PRACTICAL BANK CREDIT

SECOND REVISED EDITION

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FOREWORD

By Homer J. Livingston
Chairman of the Board
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No other single function that the banks of this country perform is more important than the extension of credit.

Bank credit plays a significant role in providing funds for the operation of business, industry, and economic activities of all kinds, as well as for the personal financial needs of millions of Americans. Some businesses borrow only occasionally from banks for special purposes. Many businesses, however, borrow regularly to take care of seasonal needs or to finance an increasing volume of business. In addition, with the growing use of instalment credit, which enables individuals to buy many types of durable goods by borrowing from banks, the lending facilities of banks are being used by more and more individuals.

A number of principles of sound lending practice have been developed through decades of experience. No banker can manage his bank in the best interests of his stockholders, his depositors, and his community if he does not understand these principles and observe them in extending credit. Moreover, there is a practical need for an integrated study in one volume, such as this one, which covers the operation of a credit department; the sources of credit information; a critical analysis of balance sheets, profit and loss statements, surplus accounts, business budgets, and trial balances; unsecured and secured loans; term loans; letters of credit; certain legal aspects of bank loans; loans on assigned accounts; and slow loans and workouts, together with a large number of practical loan illustrations. Changes in recent years in the types of bank loans and in the relative significance of the different kinds of loans, make it desirable to have these trends analyzed and well understood.

The banker can serve the growing economic needs of his community by the sound extension of credit. At the same time he must earn an adequate return for his stockholders and provide safety for his depositors.

These several responsibilities make it imperative that he understand thoroughly the principles he must observe if he is to extend credit safely and for the mutual benefit of the borrower and the bank

This book presents a comprehensive discussion of one of the most important responsibilities of bank management—the extension of credit On this subject no banker can be too well informed

PREFACE

THE LOAN-MAKING ACTIVITIES OF COMMERCIAL BANKS AND TRUST companies constitute one of the most significant phases of their operations. Prior to the mid-thirties, earnings from loans and discounts constituted the largest single item in the profit-and-loss statements of most banking institutions. Then for some years loans and discounts seemed to occupy a less important position in the earning assets of the average bank. This was the result of the large investment in the obligations of the United States Government. The increased and expanded activities of the Federal government during the economic depression of the thirties, followed by the defense and war programs of the forties, resulted in large expenditures by the Federal government, accomplished by means of deficit financing. Obviously the investments of the banks in the obligations of the United States increased, and they came to bulk larger and larger in the bank portfolios.

In the year ended on December 31, 1950, loans constituted 41.2 per cent and bond investments 58.8 per cent of total loans and bond investments of $126.6 billion for all commercial banks. The percentage in loans rose from 41.2 per cent on December 31, 1950 to 51.3 per cent on December 31, 1955. In the same period the percentage in bond investments fell from 58.8 per cent to 48.7 per cent. The latest figures available for all commercial banks indicate that on April 12, 1961, loans amounted to 58.9 per cent and bond investments to 41.1 per cent of total loans and bond investments of $197.5 billion. Since 1950, therefore, there has been almost a complete reversal in the percentage figures. However, even in 1950 the sound management of loans amounting to $52.2 billion represented a responsibility of the greatest importance.

The loan-making activities are the economic lifeblood not only of banking and financial institutions but, in many ways, of our whole system of free enterprise.

In view of these facts, it is strange that there should be a dearth of practical literature on loan operations. A number of volumes have been published on the general subject of financial statement analysis, but none of them has discussed the matter essentially from the point of view of

those men who have spent years of their lives in banking but who would like an opportunity to refresh their thinking by a study of statement analysis, loan-making experiences of other bankers, and special phases of the subject of particular interest to them.

H. V. P.
R. A. F.

SPECIAL ACKNOWLEDGMENTS

ACKNOWLEDGMENTS HAVE BEEN MADE IN THE PREFACE AND IN various parts of this book to those who have made contributions to it. The extension of credit has become so specialized that few persons, if any, are authorities in every kind of bank credit. Consequently the authors have sought and obtained the generous co-operation of many bankers who have acquired unusual competence in making various types of loans.

We should like to acknowledge particularly the following persons who have written certain chapters of the book:

Chapter Sixteen: Loans on Assigned Accounts, William R. Chapman, president, Midland National Bank of Minneapolis.

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Chapter Eighteen: Term Loans, Edward F. Blettner, executive vice-president, and Rudolph E. Palluck, vice-president, The First National Bank of Chicago.

Chapter Nineteen: Farm Loans, K. J. McDonald, chairman, Ravalli County Bank, Hamilton, Montana.

Chapter Twenty: Letters of Credit and Bankers' Acceptances, Bentley G. McCloud, Jr., vice-president, The First National Bank of Chicago.

Chapter Twenty-two: The Legal Aspects of Bank Loans, Christopher W. Wilson, senior vice-president and general counsel, The First National Bank of Chicago; and Joseph J. Kaberna, president, First Capital Corporation of Chicago, who gave helpful suggestions and material for several chapters.

part one

THE BANK CREDIT DEPARTMENT

chapter I

OPERATIONS AND FUNCTIONS

LOANS MADE BY COMMERCIAL BANKS AND TRUST COMPANIES TO their customers have constituted for many years the largest single item in the earning assets of American banks, followed by investments in United States Government and other securities. During some years, however, the difference in the amount of income from current operations in each of these two sources has tended to become less as the percentage derived from loans and discounts became smaller, and as the percentage derived from investments, primarily in the securities of the United States Government, increased.

This trend developed particularly during the depression of the 1930's, when there was a relatively small demand for bank loans and when the Federal government was engaged in financing a budget deficit by the sale of government securities, many of which found their way into the bond portfolios of banks. The development was further accelerated by World War II, the financing of which resulted in billions of dollars of government obligations finding their way into bank investment accounts. This is illustrated by the fact that 47.60 per cent of the aggregate income from current operations of all national banks for the year ending December 31, 1940, was derived from loans and discounts, and 32.85 per cent from interest and dividends on investments. For the year ending December 31, 1945, five years later, the income from loans and discounts had dropped to 27.73 per cent, and the income from investments had increased to 55.18 per cent. However, with the end of the war and the return to peace, loans and discounts again became the principal earning asset of national banks. For the year ending December 31, 1948, the income from loans and discounts was 46.86 per cent and from the interest and dividends on invest-

ments, 36.29 per cent. By December 31, 1960, the income from loans and discounts had risen to 63.63 per cent, and the interest and dividends on investments had declined to 21.71 per cent.

Without exception every loan made by a banking institution involves some element of risk. The hazard may lie in a decline of unusual magnitude in the market value of securities listed on stock exchanges or traded in over the counter, in a sudden or radical change in the managerial policies of business enterprises, in strikes, in inertia, in a drop in the market value of raw materials or of manufactured products, or in a fear psychosis that contracts sales and profits. The unpardonable sin in bank lending is to grant a loan with an inadequate background of essential credit data. Nevertheless, loans are sometimes actually made without obtaining essential information regarding a borrower's ability to repay. All too frequently in such cases the banker ultimately finds that recovery is exceedingly difficult.

In still other cases borrowers have been known to obtain loans from two or three banking institutions without revealing this fact to any of them. In such instances losses would have been avoided by a simple request for a current financial statement, which would have placed the borrower under the obligation of revealing his exact financial condition.

The two essential principles of good banking are safety and profits. The operations of a commercial bank or trust company must be sufficiently profitable to meet running expenses and normal losses, provide a reasonable amount for reserves against future contingencies, and assure a fair return to the stockholders for the use of the funds furnished by them and for the investment risk they have assumed. On the other hand, operations must be carried on safely if the bank is rightly to merit public confidence and to continue in active business.

To safeguard depositors, to serve his community properly, and to make a fair profit for his stockholders, a banker must assume risks in the extension of credit, but these risks must be held to a reasonably safe minimum. To know how far he may go in assuming credit risks is a serious responsibility of the banker.

The only sound basis for the extension of credit is complete and accurate information regarding every detail pertinent to a borrower's credit standing. Moreover, with constant changes in the financial condition of many of a bank's customers, credit data must be kept current if it is to be helpful in the granting of loans. This is likewise true in the handling of the bank's investment portfolio. Credit data can best be collected and maintained by a credit department or, at least, by one or more persons who specialize in credit work.

THE DEVELOPMENT OF THE BANK CREDIT DEPARTMENT

In *A Practical Treatise on Banking*, published over one hundred years ago, James William Gilbart, then the progressive general manager of the newly organized London and Westminster Bank in London, England, emphasized in a practical manner that every banker should keep an "information book." Banker Gilbart held that this book should contain "the character of all the houses about whom [sic] he has had occasion to make inquiries." He continued:

> There is no doubt that a banker of great experience, and of a strong memory, may always bear in his mind a very correct estimate of the standing and character of all the houses that usually come under his notice. But this does not supersede the necessity for recording his information in a book. His memory may fail, and that too on important occasions; and certainly if he leave the bank for a short time, as he must sometimes have occasion to do, he will carry his memory with him. But if the Information Book be closely kept up, he will record his knowledge for the use of those who will have to take his place. It is no valid objection to the keeping of such a book, to say that the position of houses is perpetually changing. Those changes should be recorded, so that their actual standing should always be readily referred to. If a banker is requested by a customer to make inquiry about a house, he should record the information he gets for his own guidance, in case any bills on that house should afterwards be offered him for discount.[1]

The establishment of credit departments in American banking institutions probably dates from about 1890. The exact date of the organization of the first bank credit department is unknown, but in November 1892, James G. Cannon [2] delivered an address on bank credits at Drexel Institute, Philadelphia, in which he stated that there were then no more than half a dozen credit departments in as many banks in the United States.[3] There were 9,338 active banking institutions in the country at that time, represented by 3,759 national banks, 3,191 state banks, 168 loan and trust companies, 1,059 savings banks, and 1,161 private banks.[4]

Even by 1900 credit departments of banking institutions and mercantile

[1] James William Gilbart, *A Practical Treatise on Banking* (2nd ed., New York: George P. Putnam, 1851), pp. 16–17.

[2] At that time Mr. Cannon was a vice-president of the Fourth National Bank of New York. In June 1914 the Fourth National Bank was absorbed by the Mechanics and Metals National Bank, and in April 1926 the Mechanics and Metals National Bank was merged with the Chase National Bank (now the Chase Manhattan National Bank), New York.

[3] Chester Arthur Phillips, *Bank Credit* (New York: The Macmillan Company, 1923), p. 144.

[4] *Report of the Comptroller of the Currency* (1892), Vol. 1, pp. 85–6.

houses were few and far between, and those few were generally regarded as visionary experiments Some progress had been made in the establishment of credit departments in banking institutions in New York City The National Shawmut Bank and the First National Bank, both of Boston, instituted credit departments in 1903, and several of the principal banking institutions of Philadelphia established credit departments at approximately the same time [5]

Naturally the credit information that these early departments gathered and analyzed was less extensive and less authoritative than that obtained about the typical borrowing account today The practice of exchanging information between banks and of making periodic comprehensive trade investigations was still to be developed The technique of setting up successive financial statements in parallel columns to aid in the interpretation of figures and in understanding their trends was hardly known Accountants and auditors were just becoming established in the routine of American business under the aegis of investment banking houses The first law providing for certified public accountant examinations was passed by the legislature of the State of New York in 1896, the second, by the legislature of Pennsylvania in 1899, and the third, by the legislature of Maryland in 1900

The development of bank credit departments farther west followed later Credit departments were established in Chicago banks in the early nineteen hundreds A credit department was organized in the First National Bank of Denver in 1903, in the National Bank of Commerce of St. Louis in 1905, and in the First National Bank of San Francisco in 1907 [6] The Federal Reserve Act of 1913, with its requirements for eligible paper, became a powerful, active influence in emphasizing the practical value of the work of the credit department. The American Bankers Association and the various state bankers' associations became most persistent in stressing sound credit studies as an absolute necessity for healthy banking operations

ANALYSIS OF OPERATING FIGURES OF NATIONAL BANKS

The need for experienced, constructive work by the bank credit department is illustrated in a study of the losses incurred on loans and discounts over the years by the commercial banking institutions of the country

[5] Phillips, *op cit.*, p 145
[6] *Ibid.*, p 147

Although moderate losses are inevitable over a period of time, it is axiomatic that credit will be extended properly and that losses will be held to a minimum only in those banks where thorough, periodic credit investigations are made of every borrowing account and where all information so obtained goes through the hopper of diligent and qualified credit analysis. An examination of the operating records over the years of national banks and of member banks of the Federal Reserve System (see Figures 1 and 4) gives some indication of the aggregate credit losses that might have been reduced under more capable credit supervision.

Loans and Discounts

The figures for the year ending December 31, 1960, shown in Figure 1, indicate that 63.63 per cent of the total earnings from the current operations of the 4,530 national banks came from interest and discount on loans. This was the largest single item of earnings from current operations and amounted to $3,662,497,000, in contrast to interest and dividends on investments, which totaled $1,249,379,000.

The percentage of the current earnings represented by interest and discounts declined steadily from 1941 to 1945, reaching a low for the year ending December 31, 1945, of 27.73 per cent. For the year ending December 31, 1946, there was a moderate increase when interest and discount on loans accounted for 32.23 per cent of the total earnings from current operations. In 1947 the figure reached 40.95 per cent; and in 1948, 46.86 per cent.

Looking back even farther, it is interesting to note that in the prosperous fiscal year ending June 30, 1928, interest and discount on loans amounted to $817,231,000, or 63.59 per cent of the total earnings of all national banks from current operations.[7] For the year ending June 30, 1932, this item amounted to $615,357,000, or 57.77 per cent of the earnings from current operations.[8]

In the years 1950 to 1960 inclusive, interest and discount on loans never fell below 50.32 per cent of the total earnings from current operations and generally ran from approximately 54 per cent to 63 per cent.

The movement of interest rates on business loans during recent years, is indicated in Figure 2, on page 8, which gives the average interest rates

[7] *Annual Report of the Comptroller of the Currency* (December 2, 1929), p. 56.
[8] *Annual Report of the Comptroller of the Currency* (December 5, 1932), p. 58.

Figure 2 Prevailing Rates Charged to Customers on Business Loans* by Banks in Principal Cities

Monthly Average	Nineteen Cities Average Per Cent	New York City Average Per Cent	Seven Other Northern and Eastern Cities Average Per Cent	Eleven Southern and Western Cities Average Per Cent
1929	5.83	5.76	5.82	5.93
1930	4.85	4.39	4.84	5.40
1931	4.30	3.82	4.26	4.90
1932	4.71	4.20	4.81	5.21
1933	4.27	3.43	4.46	5.04
1934	3.45	2.45	3.71	4.32
1935	2.93	1.76	3.39	3.76
1936	2.68	1.72	3.04	3.40
1937	2.59	1.73	2.88	3.25
1938	2.53	1.69	2.75	3.26
1939	2.10	1.80	2.00	2.50
1940	2.10	1.80	2.00	2.50
1941	2.00	1.80	1.90	2.50
1942	2.20	2.00	2.30	2.60
1943	2.60	2.20	2.90	2.80
1944	2.40	2.10	2.70	2.80
1945	2.20	2.00	2.50	2.50
1946	2.10	1.80	2.10	2.50
1947	2.10	1.80	2.20	2.60
1948	2.57	2.26	2.59	2.98
1949	2.68	2.37	2.71	3.10
1950	2.69	2.37	2.68	3.19
1951	3.11	2.83	3.09	3.52
1952	3.49	3.28	3.47	3.84
1953	3.69	3.47	3.68	4.04
1954	3.61	3.36	3.62	3.97
1955	3.70	3.48	3.70	4.03
1956	4.20	4.04	4.22	4.42
1957	4.62	4.47	4.63	4.83
1958	4.34	4.12	4.34	4.67
1959	5.00	4.83	5.01	5.23
1960	5.16	4.97	5.15	5.45

* *Business Statistics*, U.S. Department of Commerce, *Office of Business Economics, 1961*), p. 84.

Source Board of Governors of the Federal Reserve System. Data represent averages of rates charged on short term loans (those maturing in one year or less) to business in the specified cities.

Figures through 1938, shown in italics and not comparable with succeeding data, are weighted averages of the prevailing rates (i.e., rates for the bulk of loans) for the week ending the 15th of each month that banks reported as charging customers *for loans represented by prime commercial paper eligible for rediscount at the* Federal Reserve Banks under the provisions of the Federal Reserve Act.

Figures beginning 1939 are a revised series of interest rates adjusted for changes in the size composition of loans and, therefore, more accurately reflect variations over time in the level of interest rates. The revised report form (introduced June 1948) calls for the amount of the loans and the interest rate actually charged for each new loan or renewal made in the first half of March, June, September, and December by a selected sample of banks (mainly large ones) in 19 leading cities. To afford a comparison between rates beginning June 1948 and earlier data, the old interest-rate reports were reworked back to March 1939 to provide estimates of average rates charged using a constant system of weights derived from the size-of loan data reported since June 1948. The reworked data, therefore, eliminate certain erratic fluctuations and long run trends formerly introduced by shifts in the size composition of loans.

To adjust for size-of loan differences, averages of rates paid on each size group of loans in each area are computed. This is done by dividing the dollar amount of

in nineteen cities, including New York City, seven other northern and eastern cities, and eleven southern and western cities for the years 1929 through 1960.

The average interest rates in each of these groups follow the same general pattern. New York City had the lowest rates for each of these years. The rates for the seven other northern and eastern cities were somewhat higher, and the rates for the eleven southern and western cities were even slightly higher, with the exception of the years 1943 and 1945. In each group, with minor variations, the average rates dropped from 1929 to the 1930's held at low levels for a number of years, and from 1947 to 1960 generally moved upward. The low was 1.69 per cent for the New York City banks, 1.9 per cent for the commercial banking institutions in the seven other northern and eastern cities, and 2.5 per cent for those in the eleven southern and western cities. There was a greater spread between the high of 5.76 per cent in 1929 and the low of 1.69 per cent in 1938 charged by the New York City banks than between the highs and lows of either the northern and eastern banks or the southern and western banks—especially the latter, where rates had a tendency to be somewhat more stable. Moreover, this table emphasizes the declining profitability in some years of carrying out the primary banking function of granting loans and discounts for seasonal needs.

The relatively small volume of loans and discounts during World War II and the decline in the average interest rates during the same period caused the income from interest and discount on loans to decline to a low point. As was to be expected, however, with the cessation of hostilities, and as industry turned to the task of satisfying the tremendous pent-up demands for civilian peacetime goods, larger and larger bank loans were required. The loans and discounts of all national banks as of December 31, 1945, had increased to $13,948,000,000. Sustained demand caused this trend

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interest charged, figured at an annual rate, by the dollar amount of loans made in each group of loans. The resulting rate averages for the minor-size groups for each area are then combined into four major-size groups of loans for the area. The weights used for this computation are based on the importance in each area of the minor-size groups in the loan portfolios of reporting banks, as of November 20, 1946.

Data for bank rates on business loans for 1929–47 are annual averages; beginning 1948, quarterly averages. Data for discount rate, New York Federal Reserve Bank, and for savings deposits (except beginning July 1956 for U.S. postal savings) are as of the end of the year.

Revised series; comparable with succeeding data (see Note 1 for this page). Averages of rates for January and February 1939 comparable with series shown through 1938 are as follows: 19 cities, 2.58 per cent; New York City, 1.72 per cent; 7 other northern and eastern cities, 2.83 per cent; 11 southern and western cities, 3.29 per cent.

Bank rates beginning 1948 are averages of quarterly data.

to continue, and by December 31, 1950, loans and discounts had risen to $29,277,000 000, which far exceeded the high of the properous twenties By December 31, 1960, the figure had reached $63 693 000 000 Loans and discounts for all national and all active banks from 1936 to 1960 are given in Figure 3, page 10

Figure 3 Loans and Discounts—December 31, 1936 to 1960 (*in millions of dollars*)

	NATIONAL BANKS		ALL ACTIVE BANKS†	
	Number of Banks	Loans and Discounts	Number of Banks	Loans and Discounts
1936	5 331	$ 8 271	15 704	$ 21 613
1937	5 266	8 814	15 463	22 343
1938	5 230	8 489	15 265	21 535
1939	5 193	9 044	15 096	22 375
1940	5 150	10 028	14 956	23 976
1941	5 123	11 752	14 885	26 838
1942	5 087	10 201	14 722	24 001
1943	5 046	10 134	14 621	23 674
1944	5 031	11 498	14 579	26 102
1945	5 0 3	13 948	14 599	30 467
1946	5 013	17 310	14 633	35 823
1947	5 011	21 480	14 755	43 231
1948	4 997	23 819	14 735	48 453
1949	4 981	23 928	14 705	49 828
1950	4 965	29 277	14 666	60 711
1951	4 946	32 424	14 636	68 001
1952	4 916	36 120	14 596	75 9 9
1953	4 864	37 944	14 538	80 920
1954	4 796	39 828	14 388	86 058
1955	4 700	43 560	14 265	100 575
1956	4 659	48 248	14 188	110 632
1957	4 627	50 502	14 103	115 760
1958	4 595	52 796	14 034	122 287
1959	4 542	59 962	13 984	136 409
1960	4 530	63 693	13 971	145 255

Ninety-eighth Annual Report of the Comptroller of the Currency (1960), pp 282–3

Interest and Dividends

Today the second largest source of earnings is interest and dividends on bonds stocks, and other securities, particularly interest on obligations of the United States Government During the year ending December 31, 1960, earnings from this source amounted to $1,249,379 000 for national banks Of this total, $941 697,000 was accounted for by interest on obligations of the United States Government or its agencies This figure represents an increase from the year 1950, for example, when earnings from these sources amounted to $722,863,000 By comparison, interest and discount on loans in 1960 amounted to $3,662,497,000 and in 1950 to $1,103,360 000

In the boom year ending June 30, 1928, interest and dividends on investments amounted to $311,338 000, or 24 23 per cent of the earnings of

national banks from current operations.[9] For the year 1932 this income amounted to $298,841,000, or 28.06 per cent of the total earnings,[10] and for 1937 it accounted for 39.15 per cent of the earnings.[11]

During the war years there was a marked increase in the percentage of the earnings derived from this source, for the defense efforts of the early nineteen-forties necessitated unprecedented expenditures and financing by the Federal government. Thus, the obligations of the Federal government came to bulk larger and larger in the portfolios of all banks, and in 1945 were such that, despite the low level of the rate of interest, earnings from dividends and interest in the national banks had risen to $744,584,000, or 55.18 per cent of their total earnings. This percentage increase reflects, first, the efforts of banks to increase their earnings during the early and mid-thirties, when there was a lessened demand for loans for commercial, industrial, and speculative purposes, and, second, the defense and war periods, when Federal debt financing soared astronomically.

In carrying out the loan program, the credit department obviously must play a significant role. But in many banks without bond, statistical, or special collateral departments, it may also have at least a share in the important responsibility of watching the bank's bond and security portfolio. Under such circumstances it may be charged with the duty of maintaining accurate and up-to-date information on all corporations, both private and public, whose securities are owned by the bank. In a sense, then, the credit department may be the watchdog of the bank's treasury in connection with both its loans and its investments.

Salaries and Wages

The largest single item of expense in the operation of a bank is salaries and wages. Salaries and wages of 4,530 national banks for the year ending December 31, 1960, amounted to $1,370,603,000, or 39.64 per cent of the total expenses. These figures are subject to small modification, since fees paid to directors and members of executive, discount, and advisory committees, amounting to $25,797,000—or 0.70 per cent—are not included.

The dollar amount of salaries and wages has risen steadily during recent years. The percentage of this one charge in an entire year's operating expenses has risen from a low of 27.42 per cent in 1928[12] to the high of

[9] *Annual Report of the Comptroller of the Currency* (December 2, 1929), p. 56.
[10] *Annual Report of the Comptroller of the Currency* (December 5, 1932), p. 58.
[11] *Annual Report of the Comptroller of the Currency* (covering the year ended October 31, 1938), p. 97.
[12] *Annual Report of the Comptroller of the Currency* (December 2, 1929), p. 56.

Figure 4 Earnings of all Member Banks of the Federal Reserve System

Earnings Expenses, Dividends

(Earnings in thousands assets and liability items in millions of dollars)

Item	1952	1953	1954	1955	1956	1957	1958	1959	1960
Earnings	4 119 649	4,590,226	4 878 113	5,342 589	6 078,173	6,770,958	7 124 594	8 074 068	8 927 948
Interest and dividends on securities									
U S. Govt	979 207	1 011,000	1 066 375	1,118,106	1 100,595	1 167 739	1 268,176	1,298 835	1 414,361
Other	234 528	251,777	272,808	295,606	307 846	339 451	411,403	444 852	467 351
Interest and discount on loans	2,269 944	2 591 483	2,662,188	3 021,843	3,882,480	4,136 113	4 245 404	4,925 948	5 840,438
Other charges on loans	35,936	40,539	49 079	61,962	82,885	71,905	80 902	95 397	89,469
Service charges on deposits	197 734	218,831	252 988	274,024	320,185	354,187	398,500	421,689	463,444
Other charges fees etc	82,871	92,324	102,484	109 755	121,385	138 538	139,886	145,399	182,140
Trust department	194,630	207 219	235 453	266 992	309 105	340 234	364,360	408,503	442,063
Other current earnings	174,901	177 065	185 274	194,907	203 719	224,875	230,163	230,545	248,360
Expenses	2,501 091	2,761,519	2,998 535	3 265 126	3,679 898	4 222,375	4 616 925	5,139 614	5,654,675
Salaries—officers	406,230	447 142	478,877	511,736	553,292	592,380	632,051	680 090	721,508
Salaries and wages—others	833 300	924,348	983 620	1,059 667	1,161,906	1,264 885	1 349 170	1,438,281	1 557 204
Directors fees etc	21,514	23,714	25 541	27 189	29 161	30 858	32,495	34,586	36 984
Interest on time deposits	344,503	424 738	493 649	543,123	645 679	927 199	1,123,415	1,279,719	1 434 259
Interest on borrowed money	19 825	22,657	7 885	21 942	43,793	47 873	23,183	75 898	84 220
Taxes other than income	117 639	125 192	140,162	148,987	157 227	172 171	185 234	211,003	236 522
Recurring depreciation	60 064	67 047	75 629	86 837	102,854	117 071	134,748	153,411	167 791
Other current expenses	673,898	746,661	792,874	865 647	961 985	1,049 938	1 136,606	1,266 646	1,404,287
Net current earnings before income taxes	1 618,558	1 829,718	1 827 578	2,077 463	2,398 275	2,548,583	2 509 669	2 935 254	3,273,183
Recoveries transfers from reserves and profits	125 008	132,274	531 971	212,508	225 807	169 938	777 390	296,179	603,710
On securities									
Recoveries	9 954	9 847	11,709	10,317	12,578	8,190	8,157	25 448	10,736
Transfers from reserves	19 946	25 877	43,142	87 547	39 743	19 345	54 261	104 235	51,287
Profits on securities	29 047	34 603	374 610	50,668	27,528	67 182	611,514	41,893	283,991
On loans									
Recoveries	16 966	23,158	27 353	20 741	14 309	14 037	15 848	12,892	19 883
Transfers from reserves	24 734	15 729	54,558	47 720	72,279	26 848	29 679	53,173	66,545
All other	24 660	23 060	40,599	37 508	58,370	34,257	47 931	55,738	71,868
Losses, charge-offs and transfers to reserves	308 381	363 477	478 263	613 859	878 630	655 063	681,456	1,199 926	847 465
On securities									
Losses and charge-offs	83 851	129 880	58 549	195 493	278 573	206 908	74,869	666 514	195,528
Transfers to reserves	27 040	48 299	118 857	63 096	97 001	78,269	253 252	157 997	142,435
On loans									
Losses and charge-offs	15 652	20 618	17 771	17 943	21 851	15 875	15 109	15 382	22 813
Transfers to reserves	132 896	111 976	196 140	265 832	407 544	280 887	240 813	273 068	389 654
All other	46,942	62 908	87 946	71 904	78 862	73 324	97 353	86 965	96 835
Profits before income taxes	1 437 185	1 597 515	1 900 286	1,676 013	1 744 253	2,063,458	2 605 603	2,031 507	2 929 638
Taxes on net income	607 850	692,252	804 188	690 770	717 688	894 515	1 148 409	774 622	1 240 662
Federal	578 682	660 206	762 686	655 361	677 206	849 679	1,081 498	729,418	1 165 534
State	29 168	32,045	41 502	35 410	40 482	45 836	66 911	46 204	75 128
Net profits	829,335	905 263	1,096 098	985 242	1 026 565	1 168,944	1 457 194	1,256 885	1 688 976
Cash dividends declared	390 430	418 652	456,145	500,941	546 931	603 767	646 178	689 721	734 830
On preferred stock[1]	2 310	1,955	2,030	1 730	1,592	1,485	1 566	1 461	1,173
On common stock	388 121	416 697	454,114	499 211	545,339	602,282	644 612	688 260	733,657
Memoranda items									
Recoveries credited to reserves									
On securities	4,308	787	2,036	2 719	3 185	2,099	8,919	2,846	20,478
On loans	29,085	35,930	34 483	33,595	35 443	43,673	41,132	65 060	58 051
Losses charged to reserves									
On securities	24 643	33 978	15 247	65 502	92 830	71 394	18,823	195 044	43 892
On loans	64 930	74 494	74 744	75 651	108 536	100 611	109 169	101 998	132,762
	Assets deposits and capital accounts								
Loans	51,149	56 142	57,613	64 651	74,279	79 924	80 819	89,940	94 871
U S Govt. securities	51 911	51 091	54 485	53 453	47 554	46 901	51 804	50,125	45 609
Other securities	11 557	11 923	12 944	13 876	13 421	13 579	15 721	16 478	16 010
Cash assets	35,864	35 608	35 774	36 047	36 924	37 435	37 915	38 402	39 063
Other assets	1,977	2,049	2,304	2,020	2,093	3 450	2,893	4,047	4,719
Total assets	152 079	156 813	162,921	170,646	175 061	179 569	189 953	197 896	202 880
Time deposits	32,120	34 647	39 053	39 993	41 290	44 596	51 054	54 142	55,595
Total deposits	138,390	142,350	148 198	154 454	157,581	160 753	170 058	176 303	177 842
Total capital accounts	10 480	11 063	11 724	12,499	13 270	14,109	15 066	15 898	16 920
Number of officers	52,652	54,639	56,541	58,923	61 325	63,410	65 894	68 702	71,689
Number of employees	300 865	311 972	323,945	342,181	363,639	376 317	381,086	399,285	418 338
Number of banks	6 798	6,743	6 660	6,543	6,462	6 393	6,312	6 233	6,174

Source: *Federal Reserve Bulletin*

Figure 4 (Continued)

(Computed from aggregate dollar amounts: ratios expressed as percentages)

Item	1952	1953	1954	1955	1956	1957	1958	1959	1960
Summary ratios:									
Percentage of total capital accounts:									
Net current earnings before income taxes	15.4	16.4	15.6	16.6	18.1	18.1	16.6	1.85	19.5
Profits before income taxes	13.7	14.1	16.2	13.4	13.1	14.6	17.3	12.8	17.4
Net profits	7.9	7.8	9.3	7.9	7.7	8.3	9.7	7.9	10.0
Cash dividends declared	3.7	3.8	3.9	4.0	4.1	4.3	4.3	4.3	4.4
Percentage of total assets:									
Total earnings	2.71	2.93	2.96	3.13	3.47	3.77	3.75	4.08	4.42
Net current earnings before income taxes	1.06	1.15	1.12	1.22	1.37	1.42	1.32	1.48	1.62
Net profits	.55	.55	.67	.56	.59	.65	.77	.64	.84
Sources and disposition of earnings:									
Percentage of total earnings:									
Interest and dividends on:									
U. S. Govt. securities	22.5	22.0	22.1	20.9	18.1	17.3	17.8	17.3	15.8
Other securities	5.7	5.5	5.7	5.6	5.1	5.0	5.8	5.5	5.2
Earnings on loans	56.0	57.3	56.2	57.7	61.3	62.1	60.7	62.2	64.2
Service charges on deposit accounts	4.8	4.8	5.2	5.1	5.1	5.2	5.4	5.2	5.2
Other current earnings	11.0	10.4	10.8	10.7	10.4	10.4	10.3	9.8	9.6
Total earnings	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Salaries and wages	30.2	29.9	30.3	29.4	28.5	27.7	27.8	26.2	25.6
Interest on time deposits	8.8	9.3	10.2	10.2	10.7	13.7	15.8	15.8	16.1
Other current expenses	21.7	21.4	21.6	21.5	21.3	21.0	21.2	21.6	21.6
Total expenses	60.7	60.6	62.1	61.1	60.5	62.4	64.8	63.6	63.3
Net current earnings before income taxes	39.3	39.4	37.9	38.9	39.5	37.6	35.2	36.4	36.7
Net losses including transfers (or recoveries and profits, +)	4.4	5.4	+1.5	7.5	10.8	7.1	+1.3	11.2	3.9
Taxes on net income	14.8	15.1	16.7	13.0	11.8	13.2	16.1	9.6	13.9
Net profits	20.1	18.9	22.7	18.4	16.9	17.3	20.4	15.6	18.9
Rates of return on securities and loans:									
Return on securities:									
Interest on U. S. Govt. securities	1.79	1.98	1.96	2.09	2.31	2.53	2.45	2.79	3.10
Interest and dividends on other securities	2.03	2.11	2.12	2.13	2.29	2.50	2.62	2.70	2.92
Net losses (or recoveries and profits, +)[1]	.10	.20	+.47	.28	.53	.35	+.79	1.19	+.12
Return on loans:									
Earnings on loans	4.51	4.69	4.71	4.77	5.02	5.32	5.35	5.65	5.93
Net losses (or recoveries, +)[1]	.05	.08	.05	.06	.11	.07	.06	.04	.18
Distribution of assets:									
Percentage of total assets:									
U. S. Govt. securities	34.1	32.6	33.4	31.3	27.2	25.7	27.2	25.3	22.6
Other securities	7.6	7.6	7.9	8.1	7.7	7.6	8.3	8.3	7.9
Loans	33.6	35.8	35.3	37.9	42.4	44.0	42.5	44.9	47.8
Cash assets	23.4	22.7	22.0	21.1	21.1	20.8	20.0	19.4	19.3
Other assets	1.3	1.3	1.4	1.6	1.6	1.9	2.0	2.1	2.4
Other ratios:									
Total capital accounts to:									
Total assets	6.9	7.0	7.2	7.3	7.6	7.9	7.9	8.0	8.3
Total assets less U. S. Govt. securities and cash assets	16.2	15.8	16.1	15.4	14.6	14.7	15.0	14.5	14.3
Total deposits	7.6	7.8	7.9	8.1	8.4	8.8	8.9	9.0	9.5
Time to total deposits	23.2	24.3	25.7	25.9	26.1	27.7	30.0	30.7	31.3
Interest on time deposits to time deposits	1.13	1.23	1.30	1.36	1.58	2.08	2.20	2.36	2.58
Number of banks	6,798	6,743	6,660	6,543	6,462	6,393	6,312	6,233	6,174

[1] "Net losses" is the excess of (a) actual losses charged against net profits plus losses charged against valuation reserves over (b) actual recoveries and profits credited to net *profits plus recoveries credited to valuation reserves;* "net recoveries and profits" is the reverse. Transfers to and from valuation reserves are excluded.

NOTE.—The ratios in this and the following three tables were computed from the dollar aggregates shown in preceding tables. Many of these ratios vary substantially from the average of individual bank ratios, which will be published in a subsequent issue, in which each bank's figures—regardless of size or amount—are weighted equally and in general have an equally important influence on the result. In the ratios based on aggregates presented here, the experience of those banks in each group whose figures are largest have a much greater influence than that of the many banks with smaller figures. (For example, the 110 largest member banks have total earnings which, combined, are larger than those of all the other member banks, numbering about 6,100.) Ratios based on aggregates show combined results for the banking system as a whole, and, broadly speaking, are the more significant for purposes of general analyses of credit and monetary problems, while averages of individual ratios are useful primarily to those interested in studying the financial results of operations of individual banks.

Source: *Federal Reserve Bulletins*

49.53 per cent in 1951. In past years nearly fifty out of every one hundred dollars of operating expenses represented payments for salaries and wages. This trend has been downward since 1951 due primarily to the continued advance in interest rates paid on time deposits. The latter averaged 14.24 per cent of operating expenses in 1950 and continued rising each year, reaching a peak of 26.39 per cent of all current operating expenses in 1960.

Recoveries

The renewed and increased business activity of the late nineteen thirties and the national defense and war programs permitted the national banks to recover large amounts that previously had been charged off as losses. For the year ending December 31, 1948, recoveries on loans amounted to $48,555,000.[13] In recent prosperous years, recoveries on loans have been smaller because losses have not been as large as they were in the nineteen-thirties. For example, recoveries on loans by national banks for the year ending December 31, 1958, amounted to $11,273,000 and in the years from 1950 to 1960, inclusive, ranged from $8,558,000 to $16,502,000.

Losses

Losses constitute another major group of items that greatly affect the final earnings of all banks and trust companies and with which the credit department has a direct and significant relationship. For the year ending December 31, 1948, losses and charge-offs on loans amounted to $180,-277,000. All losses and charge-offs, including losses on bonds, stocks, and other securities, amounted to $277,443,000 and represented almost 32 per cent of the net earnings from current operations and recoveries and profits combined.

In 1934 the greatest losses in the history of national banks were charged off. The losses on loans of the 5,422 national banks in that year amounted to $379,294,000, which was almost equal to the total net earnings and recoveries of $384,834,000.[14] In addition, charge-offs on bonds, stocks, and other securities amounted to $241,789,000, making total losses of $621,083,000 for these two major items, which was substantially in excess of the total net earnings and recoveries for 1934. A final net loss of $303,546,000 was shown for that one fiscal year.

By way of comparison, an examination of the loss figures for a year of

[13] *Annual Report of the Comptroller of the Currency* (covering year ended 1948), p. 102.

[14] *Annual Report of the Comptroller of the Currency* (covering the year ended October 31, 1938), pp. 97–9.

prosperity such as 1928, when the banks were not engaged in writing off depression losses, is most interesting.

For the year ending June 30, 1928, 7,691 national banks reported[15] net earnings from operations of $327,417,000 and total net earnings, including recoveries, of $423,214,000. Of the latter figure, $19,519,000 represented recoveries on loans and discounts that had been charged off previously as losses. Losses on loans and discounts charged off during that year represented 21.7 per cent of the combined net earnings and recoveries. The same losses were equal to 35 per cent of the salaries and wages of $262,609,000. If the losses charged off on loans and discounts had been 50 per cent less, the salaries and wages could have been increased over $46,000,000 without affecting the final net profits for the year.

For the year ending December 31, 1960, the 4,530 national banks reported losses and charge-offs in securities of $122,139,000, losses and charge-offs on loans of $16,299,000, and net profit before income taxes, but after allowing for recoveries and losses, of $1,787,656,000.

As indicated by these figures, the credit policies of banking institutions receive their severest test in periods of depression. Loans become under-collateralized upon the collapse of policies adopted by the managements of business enterprises in piling up inventories, expanding plants, extending credit to marginal customers, and incurring heavy funded obligations. It is the fundamental job of the loaning officer of the bank and of the efficient credit department to anticipate such dangers and to be prepared for them. And that is not an impossible task for one who is properly trained.

Most banks experience extraordinary losses in times of recession because of business failures and the inability of businessmen to liquidate their debts in an orderly manner. A sound credit policy limits losses to an amount that a bank can reasonably withstand, and a conservative management policy sets up adequate surplus and reserve accounts in good times for the inevitably larger losses of depression periods.

This examination of the operating figures for national banks indicates phases of bank management in relation to which the work of the credit department must be most important.

ANALYSIS OF OPERATING FIGURES OF MEMBER BANKS

Interest and Dividends

Since the Federal Reserve System includes all national banks and such

[15] *Annual Report of the Comptroller of the Currency* (December 13, 1928), pp. 55–6.

state banks and trust companies that qualify and become members, the individual items of income and expense for member banks are materially larger than those for national banks alone For instance, whereas, the interest and discount on loans paid to the 4,530 national banks for the year ending December 31, 1960, was $3,662,497,000, the corresponding item for the 6,174 member banks for the year ending December 31, 1960, was $5,640,438,000

For the year ending December 31, 1929, earnings of member banks from interest and discount on loans comprised 65 per cent of the income from current operations, and interest and dividend on investments only 19 6 per cent.[16] For the year ending December 31, 1936, the percentage of income from interest and discount on loans had declined steadily to 40 4 per cent, and the income from interest and dividends on investments had increased to 38 3 per cent [17]

With the Federal financing occasioned by the large defense and war expenditures already commented on, the earnings of all member banks derived from interest and dividends on securities increased to 46.4 per cent of total 1943 earnings and finally to 54 per cent in 1945, it declined to 35 8 in 1948 During these same years the interest and discount on loans accounted for 33 5 per cent, 28 0 per cent, and 45 6 per cent, respectively, of total earnings

For the year ending December 31, 1960, the earnings of all member banks derived from interest and dividends on securities had declined to 21 0 per cent, whereas earnings on loans amounted to 64 2 per cent of total earnings from current operations

The percentage changes of the member banks are substantially the same as those experienced by the national banks

The large increase in the obligations of the United States held by the banks relative to loans during World War II caused bank earnings from bond interest to rise sharply and to such an extent as to dwarf those from loans and discounts However, the change in this situation since the end of World War II, as revealed in the preceding figures, indicates that earnings from loans and discounts now constitute the most significant item in the earnings statements of banks The significant changes in the volume of loans and investments over a number of years are shown in Figure 5 on page 17

[16] *Twenty second Annual Report of the Board of Governors of the Federal Reserve System* (covering operations for the year 1935), p 158

[17] *Twenty fourth Annual Report of the Board of Governors of the Federal Reserve System* (covering operations for the year 1937), pp 140-41

Figure 5 Member Banks–Loans and Investments 1923–1960 (*in millions of dollars*)*

DATE	TOTAL LOANS	INVESTMENTS TOTAL	INVESTMENTS U.S. GOV'T. OBLIGATIONS
Dec. 29, 1920	$19,555	$ 5,976	$ 2,619
Dec. 31, 1921	17,394	6,088	2,581
Dec. 29, 1922	17,930	7,649	3,754
Dec. 31, 1923	18,842	7,645	3,603
Dec. 31, 1924	19,933	8,813	3,874
Dec. 31, 1925	21,996	8,888	3,728
Dec. 31, 1926	22,652	8,990	3,389
Dec. 31, 1927	23,886	10,361	3,978
Dec. 31, 1928	25,155	10,529	4,312
Dec. 31, 1929	26,150	9,784	3,863
Dec. 31, 1930	23,870	10,989	4,125
Dec. 31, 1931	19,261	11,314	5,319
Dec. 31, 1932	15,204	12,265	6,540
Dec. 30, 1933	12,833	12,386	7,254
Dec. 31, 1934	12,028	16,122	10,895
Dec. 31, 1935	12,175	17,810	12,268
Dec. 31, 1936	13,360	19,640	13,545
Dec. 31, 1937	13,958	17,794	12,372
Dec. 31, 1938	13,208	18,863	13,223
Dec. 30, 1939	13,962	19,979	14,328
Dec. 31, 1940	15,321	21,805	15,823
Dec. 31, 1941	18,021	25,500	19,539
Dec. 31, 1942	16,088	43,175	37,546
Dec. 31, 1943	16,288	57,970	52,948
Dec. 30, 1944	18,676	72,893	67,685
Dec. 31, 1945	22,775	84,408	78,338
Dec. 31, 1946	26,696	69,666	63,042
Dec. 31, 1947	32,628	65,218	57,914
Dec. 31, 1948	36,060	59,556	52,154
Dec. 31, 1949	36,230	65,297	56,883
Dec. 30, 1950	44,705	62,719	52,365
Dec. 31, 1951	49,561	62,687	51,621
Dec. 31, 1952	55,034	64,514	52,763
Dec. 31, 1953	57,762	64,660	52,603
Dec. 31, 1954	60,250	71,352	57,809
Dec. 31, 1955	70,982	64,377	50,697
Dec. 31, 1956	78,034	60,734	47,575
Dec. 31, 1957	80,950	61,403	47,079
Dec. 31, 1958	84,061	70,803	54,299
Dec. 31, 1959	94,779	63,101	46,813
Dec. 31, 1960	99,934	65,685	49,106

* Source: 1920–1941, Board of Governors of the Federal Reserve System, *Banking and Monetary Statistics* (November 1943), 18, pp. 72–4; 1942–7, *Federal Reserve Bulletin*, XXXV, No. 1 (January 1942), p. 42; 1948–51, *ibid.*, XXXIX, No. 1 (January 1953), p. 27; 1952–4, *ibid.*, XLII, No. 1 (January 1956), p. 27; 1955–6, *ibid.*, XLIV, No. 1 (January 1958), p. 41; 1957–8, *ibid.*, XLV, No. 6 (June 1959).

Salaries and Wages

Salaries and wages paid by member banks constituted the primary operating expense and showed the same percentage trend as in the case of national banks. From 27.6 per cent in 1929,[18] the ratio of salaries and wages to gross operating expenses rose steadily to 41.2 per cent in 1937.[19]

[18] *Twenty-second Annual Report of the Board of Governors of the Federal Reserve System* (covering operations for the year 1935), p. 158.

[19] *Twenty-fourth Annual Report of the Board of Governors of the Federal Reserve System* (covering operations for the year 1937), pp. 140–41.

After declining to the low dollar amount of $306,021,000 in 1933,[20] this item increased steadily each year to $425,903,000 in 1941 and to $875,793,000 in 1948. This expense continued to increase through the nineteen fifties and for the year 1960 amounted to $2,288,712,000 or 40.4 per cent of total current expenses of the member banks.

Recoveries

During the year 1945, member banks recovered $113,221,000 previously charged off on investments and $55,918,000 previously charged off on loans. Including profits on securities sold, total recoveries amounted to $453,785,000, or four times the low in 1932. In 1948, total recoveries and profits on securities had declined to $242,523,000.

In the nine years from 1952 to 1960 inclusive, the recoveries on securities of member banks fluctuated from a low of $8,157,000 in 1958 to a high of $25,448,000 in 1959 and the profits on securities, from a low of $27,526,000 in 1956 to a high of $611,514,000 in 1958. In these same years member banks reported recoveries on loans at a low of $13,892,000 in 1959 and at a high of $27,353,000 in 1954.

Losses

The test of credit department efficiency is found not only in the amount of *earnings* and *recoveries*, but also in the amount of *losses* on loans and investments. The acid test comes during periods of stress, and not during periods of widespread industrial activity such as this nation experienced during the war years of the nineteen-forties and the years following. Beginning with the comparatively small sum of $64,770,000 charged off as losses on loans in 1942, the amount charged off each year remained low until 1947, when it increased to $102,653,000; in 1948 it increased still further to $270,962,000. However, in the generally prosperous years from 1952 to 1960 inclusive, losses and charge offs reported by member banks were low and fluctuated between $15,109,000 in 1958 and $22,813,000 in 1960. The volume of loans also rose greatly in the latter years.

THE OPERATIONS OF THE BANK CREDIT DEPARTMENT

Qualifications of a Credit Man

The need for men who have the experience, the training, and the ability to analyze credit risks has been present throughout history.

[20] *Ibid.*

On one of the clay tablets of the Babylonian period, recording the business transactions of the time, there is an inscription to the effect that "In the month of Ab of the first year of Neriglissar, King of Babylon, I [Belilit] sold Bazuzu, my slave, for half a mana, five shekels of money, to Nabuahki-iddin, son of Shula, son of Egibi. I took his note, but he has not paid the money," showing that even in those days bad credit risks were in existence and good credit men necessary.[21]

To become an efficient credit man, a banker must have sufficient knowledge of accounting to understand and to interpret balance sheets, profit and loss statements, surplus accounts, and possibly budgets and trial balances as well as a statement showing the source and application of funds. In addition to this educational background, he must possess an analytical mind, a searching disposition, patience, thoroughness, alertness, fitness, self-possession, resourcefulness, tact, diplomacy, and leadership. He must conduct his credit investigations thoroughly, so that no essential facts escape his periodic review and analysis. He must be familiar with the sources of credit information, and he must have the resourcefulness and the industry necessary to obtain the required facts when they are not readily available. He must be systematic in handling the vast store of information under his supervision. A comprehensive understanding of business practices and terms of credit in many lines of business will facilitate his inquiries. He must have a mind of his own and the ability to detect and correct weaknesses in men and in businesses. He should approach his work, however, less in the spirit of the detective who seeks the worst, and more in the spirit of one who is trying to find desirable borrowers for his bank.

The banker may require a great deal of courage in some cases to say "no" to requests for loans that he feels are basically unsound. As much or more courage is needed, however, to assume the personal responsibility for extending a line of credit to a large account. Only when he operates intelligently on this basis does he serve his stockholders and the public and discharge his primary function as a commercial banker.

The banker who finds that his credit losses are consistently out of line with those reported for most banks may be reasonably certain that loans are being made without adequate credit information and judicious analysis. The credit facts must be sufficiently comprehensive to assure acceptance of a maximum of sound risks and a minimum of unsound risks. The banker who reported that his bank had had no losses on loans in over

[21] William H. Kniffin, *The Practical Work of a Bank* (7th ed.; New York: Bankers Publishing Company, 1928), pp. 424–5.

fifteen years was almost certainly declining legitimate requests for credit. His credit department was not discharging its full responsibility to the bank, the stockholders, or the community. Some idea of the magnitude of the responsibility of bankers is indicated by the growth and size of the deposits of all banks as shown in Figure 6 below.

Figure 6 Deposits and Currency—Adjusted Deposits on All Banks* and Currency Outside Banks, 1923–1960 (*in millions of dollars*)

	Total Deposits Adjusted and Currency Outside Banks	Demand Deposits† Adjusted	Total Time Deposits§	U.S. Government‡ Deposits	Currency Outside Banks
Dec 31 1923	43 503	19 144	20 379	254	3 726
Dec 31 1924	47 08	20 898	22 232	256	3 696
Dec 31 1925	50 299	22 288	23 922	318	3 771
Dec 31 1926	51 123	21 721	25 328	247	3 827
Dec 31 1927	54 082	22 730	27 372	280	3 700
Dec 31 19 8	55 638	23 081	28 681	283	3 593
Dec 31 1929	54 713	22 809	28 189	158	3 557
Dec 31 1930	53 553	20 967	28 676	305	3 605
Dec 31 1931	48 325	17 412	25 979	464	4 470
Dec 31 1932	45 362	15 625	24 457	508	4 669
Dec 31 1933	42 548	15 035	21 715	1 016	4 782
Dec 31 1934	47 985	18 459	23 156	1 715	4 655
Dec 31 1935	52 182	22 115	24 241	909	4 917
Dec 31 1936	57 351	25 483	25 361	991	5 516
Dec 3 1937	56 639	23 959	26 218	824	5 638
Dec 31 1938	58 955	25 986	26 305	889	5 775
Dec 30 1939	64 099	29 793	27 059	846	6 401
Dec 31 1940	70 761	34 945	27 738	753	7 325
Dec 31 1941	78 231	38 992	27 729	1 895	9 615
Dec 31 1942	99 701	48 922	28 431	8 402	13 946
Dec 31 1943	122 812	60 803	32 748	10 424	18 837
Dec 31 1944	150 988	66 930	39 790	20 763	23 505
Dec 31 1945	175 401	75 851	48 452	24 608	26 490
Dec 31 1946	167 107	83 314	53 960	3 103	26 730
Dec 31 1947	171 460	87 121	56 411	1 452	26 476
Dec 31 1948	171 570	85 520	57 520	2 451	26 079
Dec 31 1949	173 030	85 750	58 616	3 249	25 415
Dec 30 1950	179 906	92 272	59 247	2 989	25 398
Dec 31 1951	189 599	98 234	61 447	3 615	26 303
Dec 31 1952	200 060	101 508	65 799	5 259	27 494
Dec 31 1953	205 374	102 451	70 375	4 457	28 091
Dec 31 1954	214 194	106 550	75 282	4 510	27 852
Dec 31 1955	220 615	109 914	78 378	4 038	28 285
Dec 31 1956	225 988	111 391	82 224	4 038	28 335
Dec 31 1957	231 860	110 254	89 126	4 179	28 301
Dec 31 1958	247 111	15 507	98 306	4 558	28 740
Dec 31 1959	251 922	115 402	101 779	5 319	29 422
Dec 31 1960	259 119	115 102	108 468	6 193	29 356

* Source 1923 41 Board of Governors of the Federal Reserve System, *Banking and Monetary Statistics* (November 1943) Table No 9 p 35 1941–6 *Federal Reserve Bulletin* XXXIII No 4 (April 1947) p 53 1947 51 *ibid.*, XXXIX No 1 (January 1953) p 26 1952–5 *ibid.*, XLIII No 1 (January 1957), p 44 1956–8 *ibid.*, XLV No 6 (June 1959) p 606.

† Includes demand deposits other than interbank and U.S Government less cash items in process of collection

‡ Beginning with December 1938 includes U.S Treasurer s time deposits open account.

§ Excludes interbank time deposits U.S Treasurer s time deposits, open account, and deposits of Postal Savings System in banks

Large and Small Banks

The immense size of many modern business units led Thurman Arnold to term them "governments" in their own right.[22] In view of the complexity of their corporate structures and the extent of their international operations, the necessity for scientific credit study and investigation must be readily apparent even to the most casual student of banking. An efficient credit department is an obvious necessity in the operation of a large banking institution that grants loans to these large and complicated corporations. Credit department records are no less important, however, in the operations of smaller banks, if snap judgments and excessive credit losses are to be avoided.

In an interesting address about fifty years ago, when a "bureau of credit," or credit department, was unknown to all except a few of the larger banks, James B. Forgan stressed the idea that "a bureau of credit is a desirable department in every well-managed bank, however small," and emphasized the fact that the banker should leave credit records for those who follow him.

> The information on which a bank grants credit is obtained by the banker in his official capacity and is, therefore, the bank's property. The bank may survive him. It will if his management is good. He will one day be promoted to a higher sphere of usefulness, either in this world or the next, and there should be left behind him in the bank as good a record of the information on which his transactions with customers have been based as he leaves of the transactions themselves.[23]

Loans and Discounts

The effectiveness with which the credit department of the typical bank operates will determine in no small measure the character of its loans and discounts. Where credit information is complete and is revised at periodic intervals, the banker is better able to discriminate between desirable and undesirable risks. Consequently he makes fewer errors and holds his losses

[22] "Political and legal thinkers of our time do not consider private business organizations as 'government.' Great corporate organizations are looked at as rugged individuals. . . . The ideal that a great corporation is endowed with the rights and prerogatives of a free individual is as essential to the acceptance of corporate rule in temporal affairs as was the ideal of the divine right of kings in an earlier day." Thurman W. Arnold, *The Folklore of Capitalism* (New Haven: Yale University Press, 1937), pp. 107, 185.

[23] James B. Forgan, *Recollections of a Busy Life* (New York: Bankers Publishing Company, 1924), p. 263.

to a safe minimum He bases his credit judgment solely on the experienced interpretation of essential facts

Building up Credit Records

In a small bank the work of the credit department may conceivably constitute the part time work of one employee In larger institutions the credit work is performed by a separate department The credit department may require from two or three employees to as many as one hundred or more to handle files covering tens of thousands of individuals and business enterprises located in every part of the United States and abroad

Information on each customer is kept systematically in a separate folder Information on related accounts, such as a corporation account and the account of one or more subsidiary or affiliated concerns, at times is kept in the same folder

In addition, the credit department prepares credit folders on many non-customers The information on non-customers may be helpful in the event that the bank solicits or is offered the banking business of any of them, or in case it receives requests from its own customers, especially its correspondent banks, for information regarding them Credit information on non-customers may be placed in a less expensive and less elaborate folder, since it is generally used less frequently than information relating to customers Forms used in compiling credit folders for borrowing accounts are illustrated in the typical bank credit file at the end of this chapter

The credit department builds up credit records on every customer of the bank, but more thoroughly on those who borrow In the case of a customer who does not borrow but carries balances with the bank in the form of a checking account, the credit department obtains sufficient information to establish his identity, his reliability, and his general integrity A bank should have information regarding the character of those whose deposits it agrees to accept and to whom it gives the privilege of writing checks This is particularly true in large cities, where a prospective customer may be unknown to any officer of the bank

An individual, for example, who repeatedly writes checks when his balances are insufficient, making it necessary for the bank to return his checks, is not a desirable customer The management of a bank dislikes to decline payment of its own checks, and it will avoid accepting the account of any individual or concern whose previous banking practices, as disclosed by credit investigations with other institutions, reveal a persistent record of writing checks without maintaining adequate balances Likewise,

bankers do not wish to accept the accounts of individuals of questionable character, for it is generally a reflection upon the bank to allow them to use its checking account facilities. Consequently one of the functions of the credit department is to obtain information about the general reputation of every prospective depositor.

The greatest value of the credit department to the bank is in connection with borrowing customers. If the bank is to assume the risk of making a loan to a customer, it must necessarily have more complete information regarding the financial responsibility behind the account than if it is merely accepting a deposit to open a checking account. The credit department must obtain and analyze balance sheets, profit and loss accounts, trial balances, budgets, and bank and trade checking, and make other supplementary investigations to determine whether a depositor requesting a loan is entitled to credit. The employees of the department gather the information, classify it as to its importance, often interpret it, record it in permanent files, and supply it to those who are entitled to use it. These records must be revised constantly to reflect current conditions.

Summary

The functions and activities of the typical bank credit department may be summarized as follows:

I. Obtains and compiles credit information.

A. Secures and properly compiles information relative to the reputation, financial standing, and moral risk of the bank's customers, of those business enterprises whose commercial paper is being offered for sale in the open market, and of concerns about which inquiries have been received.

1. Investigates the makers of notes its customers seek to rediscount; also investigates endorsers of customers' notes.

2. Makes inquiries at other banking institutions about their experience with a customer who has had banking relationships with one or more banks. These are called "bank checkings."

3. Makes inquiries at business houses, generally those that have bought from or sold merchandise to the customer about whom the inquiry is being made. These are called "trade checkings."

4. Obtains information from mercantile agencies and from other collateral sources, which are discussed in later chapters.

B. Obtains information covering the various types of collateral pledged as security for loans. In some banks a part or all of the in-

formation regarding collateral may be secured and compiled by a separate collateral or statistical department. If the bank has a bond department, helpful information on securities offered as collateral is given by that department.

C. Secures and prepares for suitable use information on a wide variety of subjects helpful in making loans and serving customers, such as business and trade conditions, commodity markets, the inventory position of particular industries, price trends, business practices, and policies in various industries

II Reviews and prepares credit information for the use of others

A Receives financial statements and spreads them on special comparative statement forms Analyses of these statements are made for the use of loaning officers These analyses generally indicate the strong and weak points in the most recent financial statement and the trend of the financial condition over the years

B Revises and brings up to date periodically the information and figures contained in the credit folder

1 With the co-operation of the bank's officers, the credit department asks for financial statements regularly, particularly in connection with those customers who borrow without the specific pledge of collateral

2 Transfers old material from the current credit files to warehouses or permanent files

III Maintains the credit records and files

A Maintains a careful record of every credit folder and of all other credit information released to a loaning officer, and sees that the material is returned

B Places in the proper credit folders all letters, agency reports, financial statements, newspaper clippings, memoranda, and other useful current information

C. Supervises the safekeeping and systematic arrangement of all credit records These records must be kept confidential and available only for those entitled to them

IV Provides credit information to various groups to the loaning officers of the bank, to correspondent banks, to customers, and to business houses and other outsiders entitled to the information

A Answers credit inquiries from correspondent banks, customers, business organizations, and others who write for credit information on various names

B In large banks with foreign departments, credit information on foreign business is obtained for customers interested in selling abroad

Sellers must have some idea of the financial responsibility, paying habits, and general credit reputation of foreign buyers. Most banks are in a position to obtain this information through central reserve city correspondents or directly from foreign correspondents. The extent of the files required on foreign names is indicated by the fact that there are approximately one hundred countries in the world. One large bank has 212,000 credit files, and of that number, 150,000, or approximately 70 per cent, are on foreign names; another has 132,000 files on foreign names.

V. Additional functions.

A. May record on the average balance and loan cards the average balances maintained monthly and yearly in customers' checking accounts, and the high and low points of borrowings each month.

B. May also maintain a staff of accountants to audit the records of customers and prospective customers if the bank for some reason wishes to check these records with its own accountants.

CLASSIFICATION OF BANK LOANS

Those engaged in credit department work must have a clear conception of the classes of loan that a commercial bank makes in order to understand precisely the kind of information required by the loaning officer in making his final decisions. Loans may be classified for this purpose in two general groups: secured and unsecured.

Secured Loans

Secured loans are loans for which borrowers pledge assets of various kinds, such as stocks, bonds, mortgages, debentures, receivables, real estate, cash surrender value of life insurance, warehouse receipts for merchandise, and trust receipts. Of these various assets, listed stocks and bonds, accounts receivable, and warehouse receipts are probably the most frequently pledged. If pledged securities are traded in actively on a recognized exchange, the banker usually finds that it is relatively easy to check their current market value. The mere fact, however, that a security is listed or traded in on an exchange does not constitute adequate assurance of its merit as collateral. Unlisted stocks or bonds of a corporation with a long record of progress and satisfactory earnings may at times be better collateral than a listed security of a corporation in a somewhat extended financial position, or than one that has a limited market, or is subject to

wide fluctuations in price Unlisted securities may also be preferred when there is a wide spread between bid and asked prices on listed securities The banker must keep fully informed regarding the inherent soundness, collateral value, and marketability of all securities offered as security for a loan

With the help of his credit department, the lending officer must judge not only the moral and financial risk of a borrower who wishes to pledge securities, but also the moral and financial responsibility of the business represented by the pledged collateral As a general rule he must insist that securities pledged as collateral have a broad and active market, represent well-established businesses in relatively stable lines, and have a reasonably consistent and stable earning record The capable banker will also see to it that not too large a proportion of collateral representing any one line of business or any particular business finds its way into his bank Otherwise, he may unexpectedly find his institution in the position of owning a business in the event the loans secured by the collateral are not met at maturity X61 1 K3 50364

In banking institutions with collateral, bond, and statistical departments, these facilities are constantly available to the loaning officers in making and liquidating collateral loans In smaller banks without these specialized departments, the credit department must be equipped to give essential information regarding securities offered as collateral The bank may also call upon its correspondent banks in the larger banking centers for additional facts regarding any security about which its information is inadequate In the moderate sized bank the credit department may check over the securities offered as collateral before a loan is accepted, and may, furthermore, be charged with the responsibility of systematic and periodic follow-up of the value of the collateral until the loan is liquidated

Banks also make commodity loans against certain types of merchandise—such as butter, eggs, poultry, cotton, whisky, sugar, rice, and wheat—generally receiving from the borrower a warehouse receipt as collateral A warehouse receipt is simply a certificate issued by a warehouseman showing that certain merchandise has been stored in a warehouse and indicating who has the title to the goods Warehouse receipts today are held in high esteem as bank collateral, largely because of the widespread adoption of the Uniform Warehouse Receipts Act by many state legislatures since 1907 This legislation has improved warehousing and established more definitely the rights of all who may be interested in warehouse receipts It is important that someone in the bank thoroughly familiarize himself with the various markets for these products, the market trends,

the general inventory position—that is, whether supplies are large or small—and the laws, regulations, and trade practices governing trade in the respective commodities. The banker also should be familiar with the "said to be or contain" clause which appears on warehouse receipts, thereby absolving the warehouseman from liability if neither the quantity nor the quality of the merchandise is correctly described.

Unsecured Loans

In reality, the term "unsecured" is somewhat misleading, for, strictly speaking, a good unsecured loan is adequately secured. The borrower does not pledge collateral, but he presents a balance sheet, a profit and loss statement, and an antecedent record as the basis for the loan. The banker grants the loan on the financial strength of the business as revealed by the financial statements, together with other considerations, such as the character and reputation of the borrower, his business ability, past business experience, and relationship with the bank. The loan is not actually unsecured, in the sense that there is no assurance of payment, for it is secured by the entire business and its unpledged assets.

As a rule, an individual is required to present collateral when borrowing for personal needs. Sometimes, however, an individual borrows on his unsecured note. Unless his credit is sufficiently good to stand as its own security, the bank may require some other individual of known means to endorse the note and become contingently liable. In addition, the endorser may be required to put up collateral to support his endorsement. Personal unsecured loans, however, are ordinarily for small amounts and short terms and constitute a relatively insignificant percentage, although in very recent years a growing one, of a bank's aggregate loans.

We are particularly interested in unsecured loans made to business enterprises, about which the credit department must provide sufficient credit information so that intelligent decisions may be made. Later chapters will cover the wide variety of sources from which the credit department obtains information needed by the loan officer in passing upon requests for loans of this nature.

Credit Department

Return Promptly

This Section is a reproduction of a complete bank credit folder, reduced from eight-and-a-half by eleven inches, which is the typical size of pages in a bank credit folder.

CS 9

Name	RYAN DIE CASTING CO.		
Address	1156 E. Beverly Street, Chicago 49		
Business	Dies		
Date opened	7-31-Year F	First Deposit $ 28,000.	
Source of Account	John Adamson		
Opened by	T.F.J.		

Keith A. Williams	Pres.
James E. Lemon	Vice-Pres.
George R. Jones	Secretary
Harold J. Adams	Treasurer

Guarantors or Subordination Agreements

SUBORDINATION AGREEMENT
6-15-Year D - $15,000.
Keith A. Williams

SUBORDINATION AGREEMENT
6-15-Year D - $15,000. - James E. Lemon

SUBORDINATION AGREEMENT
6-15-Year D $15,000.
George R. Jones

SUBORDINATION AGREEMENT
6-15-Year D $15,000.
Harold J. Adams

Relations in other departments

Bank Accounts
National Bank, St. Louis

Related Accounts
Ryan Die Casting Co. Payroll A/C

Ryan Die Casting Co. Profit Sharing Trust

Remarks

BASIS: Exempt from Service Charge

Participation in development

RECORD OF OVERDRAFTS AND RETURNED CHECKS

NAME RYAN DIE CASTING CO.

CB 126

CHECKS RETURNED			OVERDRAFTS		
DATE	AMOUNT	REASON	DATE	AMOUNT	DISPOSITION

CSM

OFFICERS ANNUAL REPORT

NAME	BUSINESS	ADDRESS
RYAN DIE CASTING CO.	Manufacturers	1156 E. Beverly St. Chicago 49, Illinois

2-16-Year AA (This Year) G. Rawlins (continued)	Current assets consisted of cash $134,000, accounts receivable (net) $123,000, cash value life insurance $25,000 and inventories $143,000. Cash and receivables totalled $257,000 and were $142,000 in excess of current liabilities and $117,000 in excess of total liabilities. Inventories decreased $40,000 during the year and ending inventories related to the cost of goods sold showed a turnover of 13.4 times as compared with 12.2 times in fiscal year B. Long term debt was $25,000 and consisted of notes due officers. There have been no current borrowings since December 31, Year B. The company paid its last installment on our $66,000 term loan on May 17, Year A. Balances averaged $181,000 in Year A, as compared to $107,000 Year B.

CSM

OFFICERS ANNUAL REPORT

NAME	BUSINESS	ADDRESS
RYAN DIE CASTING CO.	Manufacturer	1156 E. Beverly St. Chicago 49, Ill.

1-28-Year A
(1 year ago)
F. Bolden

Received a copy of annual statement for the year ended B, containing financial statements as prepared and certified by Hasby Jones & Company, C.P.A.'s. Operations for the year resulted in a net profit of $62,000 after Federal income taxes of $56,000 and a depreciation charge of $38,000. This compares with a net profit for the previous year of $100,000. Net sales increased $437,000 to $2,596,000 while the gross profit margin declined 7.1% to 13.7%. Net worth increased $62,000 as a result of retained earnings.

The balance sheet showed current assets of $511,000 to pay current liabilities of $221,000 and total liabilities of $257,000. Working capital increased $70,000 to $290,000 as follows:

FUNDS PROVIDED		FUNDS APPLIED	
Net Profit	$ 62,000.	Invest in Fixed Assets	$ 16,000.
Depreciation	38,000.	Decr. in Term Debt	20,000.
Decr. Prepaid Charges	1,000.		
Decr. due from Affiliates	5,000.	Incr. in Working Capital	70,000.
Total Funds Provided	$106,000.	Total Funds Applied	$106,000.

Current assets consisted of cash $162,000, accounts receivable (net) $143,000, cash value life insurance $23,000 and inventories $183,000. Cash and receivables totalled $305,000 and were $84,000 in excess of current liabilities. Inventories decreased $52,000 during the year and ending inventories related to the cost of goods sold showed a turnover of 12.2 as compared with 10.5 times in fiscal year C. Long term debt was $66,000 and consisted of notes due officers subordinated to bank debt. Keith A. Williams guarantees the entire indebtedness.

As of September 30, Year B, the company owed $16,000 on their unsecured term loan, the final payment of which is due May 17, Year A. The balance now outstanding is $5,000. The company had been steadily in our debt on a current basis since September, Year C, with high borrowings of $44,000 until we received a clean-up in December, Year B. There have been no current borrowings since that time.

Balances averaged $107,000 as compared to $87,000 in Year C.

2-16-Year AA
(This Year)
G. Rawlins

Received a copy of the audit report for the fiscal year ended A, containing financial statements of the company as prepared by Hasby Jones & Company C.P.A.'s. Operations for the year resulted in a net profit of $30,000 after Federal income taxes of $27,000 and a depreciation charge of $34,000. For the previous fiscal year operations resulted in a net profit of $62,000. Sales for the year were $1,249,000 a decrease of $1,347,000 from the previous year's figure of $2,596,000 and the gross profit percentage increased .8 points to 14.5%. Net worth increased $30,000 to $460,000 as a result of retained earnings.

The balance sheet showed current assets of $425,000 to pay current liabilities of $140,000. Working capital increased $20,000 to $310,000 as follows

FUNDS PROVIDED		FUNDS APPLIED	
Net Profit	$ 30,000.	Invest. in Fixed Assets	$ 5,000.
Depreciation	34,000.	Decr. in Term Debt.	41,000.
Decr. Due from		Incr. Prepaid Expenses	2,000.
Affiliates	6,000.	Incr. in Misc. Assets	2,000.
		Incr. in Working Capital	20,000.
Total Funds Applied	$ 70,000.	Total Funds Applied	$ 70,000.

OFFICERS ANNUAL REPORT

NAME	BUSINESS	ADDRESS
RYAN DIE CASTING CO.	Manufacturer	1156 E. Beverly St. Chicago 49, Illinois

5-2-Year C (3 years ago) R. Samson (continued)

Current assets consisted of Cash $74,000, accounts receivable (net) $190,000, cash value life insurance $16,000 and inventories $93,000. Cash and receivables totalled $264,000 and were $71,000 in excess of current liabilities, but $31,000 short of total liabilities. Inventories increased $28,000 during the year and showed a turnover of 12.2 times to the cost of goods sold as compared to 14.8 times in Year E. Long term debt was $102,000 and consisted of $62,000 subordinated notes payable to officers and $40,000 unpaid balance of our term loan.

On August 28, Year D, we rewrote the $57,000 term made in May, Year F, which had an unpaid balance of $13,781.33, to a $66,781.33 term loan, 5% rate. This loan is repayable $2,024 monthly, having the same maturity as the original term loan. The unpaid balance is presently $50,589.33. There have been no current borrowings since May, Year F.

Balances averaged $102,000 in Year D, as compared to $61,000 in Year E.

3-16-Year B (2 years ago) T. Harrison

Received a copy of the audit report for the fiscal year ended C, as prepared and certified by Hasby Jones & Company, C.P.A.'s. Operations for the year resulted in a net profit of $100,000 after Federal income taxes of $100,000 and depreciation charges of $39,000. The profit represents an 80% increase from last year's net of $57,000. Sales for the year were $2,159,000 an increase of 50% or $716,000 from the previous year's sales of $1,432,000 and the gross profit margin decreased 0.3% to 20.8%. Net worth increased $100,000 by the addition of net profit.

The current ratio stood at 1.6 to 1 as compared to 1.9 to 1 last year, with current assets of $566,000, available to pay current liabilities of $346,000 and total liabilities of $432,000. Working capital increased $40,000 to $220,000 as follows:

FUNDS PROVIDED		FUNDS APPLIED	
Net Profit	$100,000.	Invest. in Fixed Assets	$ 27,000.
Depreciation	39,000.	Invest. in Affiliates	53,000.
		Decrease - Term Debt	16,000.
		Incr. Prepaid Expenses	3,000.
		Incr. in Working Capital	40,000.
Total Funds Provided	$139,000.	Total Funds Applied	$139,000

Current assets consist of cash $84,000, accounts receivable (net) $229,000, cash value life insurance $18,000 and inventories $235,000. Cash and receivables totalled $313,000 and were $33,000 short of current liabilities and $119,000 short of total liabilities. Inventories increased $142,000 and average inventory showed a turnover of 10.5 times to the cost of goods sold as compared to 14.4 times in fiscal Year D.

Long term debt of $86,000 consists of:

(1) $16,000 - the long term balance of our $67,000 term loan repayable $2,065 monthly to May, Year A, ($24,000 included in current liabilities).

$70,000 - A portion of the bonuses due officers, which are subordinated to bank debt.

In addition to our term loan the company borrowed $44,000 on a current basis in September, Year C, which was reduced to $35,000 in December and $30,000 in March, Year B, which amount is presently owing. We hold the guaranty of Keith Williams for the entire indebtedness.

Balances averaged $87,000 in Year C, as compared to $102,000 in Year D.

OFFICERS ANNUAL REPORT

NAME	BUSINESS	ADDRESS
RYAN DIE CASTING CO.	Manufacturer	1156 E. Beverly St. Chicago 49, Illinois

4-13-Year D
(4 years ago)
F. Norman

(continued)

FUNDS PROVIDED		FUNDS APPLIED	
Net Profit	$ 37,000.	Invest. Fixed Assets	$ 27,000.
Depreciation	26,000.	Decr. Term Loan	13,000.
Decr. Prepaid	2,000.	Incr. Working Capital	25,000.
Total Funds Provided	$ 65,000.	Total Funds Applied	$ 65,000.

Current assets consisted of cash, $62,000, accounts receivable (net) $101,000, cash value life insurance $14,000 and inventories $65,000. Cash and receivables totalled $163,000 and were $44,000 in excess of current liabilities but $15,000 short of total liabilities. Inventory was reduced $14,000 during the year and showed a turnover of 14.8 times to cost of goods sold compared to 11.3 times the previous year end.

The term debt consisted of:

(1) $27,000 which is the balance of a term loan we made the company in May, Year F, of which $11,000 is included in current liabilities. The loan was in the original amount of $57,000 and has been decreased by monthly installments of $948, which will run through May, Year A. The loan is guaranteed by Keith A. Williams, James B. Lemon, George R. Jones and Harold J. Adams. On March 13, Year D we wrote a commitment letter authorizing an increase in this loan of $60,000 prior to July 1, Year D. The terms of the original loan remain unchanged except for the monthly payments.

(2) $350, which is the long term balance on equipment purchase contracts. An additional $2,385 is included in current liabilities.

(3) $47,000 which is due to officers, represents that portion of bonuses for the past two years which have been reloaned in the form of four or five year notes to the company and are subordinated to bank debt.

There have been no borrowings on a current basis since May, Year F, when the company repaid a $9,000 loan which was on the books for three months.

Balances averaged $61,000 in Year E and $57,000 in Year F.

5-2-Year C
(3 years ago)
R. Samson

Received a copy of the audit report for the fiscal year ended D, containing financial statements of the company as prepared and certified by Hasby Jones & Company, C.P.A.'s. Operations for the year resulted in a net profit of $57,000 after Federal income taxes of $52,000 and a depreciation charge of $30,000. For the previous fiscal year operations resulted in a net profit of $37,000. Sales for the year were $1,432,000, an increase of $236,000 from the previous year's figure of $1,206,000 and the gross profit percentage increased 0.9% to 21.1%. Net worth increased $58,000 to $288,000 as a result of net profit plus surplus adjustments of $1,000. The current ratio stood at 1.9 to 1 as compared to 2.1 to 1 a year ago.

The balance sheet showed current assets of $373,000 available to pay current liabilities of $193,000 and total liabilities of $295,000. Working capital increased $56,000 to $180,000 as follows:

FUNDS PROVIDED		FUNDS APPLIED	
Net Profit	$ 57,000	Fixed Asset Additions	$ 73,000
Depreciation	30,000	Added 1953 Income Tax	3,000
Incr. Term Debt.	42,000		
Surplus Adj. Res. for Bad Debts	2,000	Incr. Working Capital	56,000
Decr. Prepaid	1,000		
Total Funds Provided	$132,000	Total Funds Applied	$132,000

CSM

OFFICERS ANNUAL REPORT

NAME	BUSINESS	ADDRESS
RYAN DIE CASTING CO.	Manufacturers	1156 E. Beverly St. Chicago 49, Ill.

3-28-Year E
(5 years ago)
H. Morris

Received a copy of the annual report for the fiscal year ended F, as Prepared and Certified to by Hasby Jones & Company, C.P.A.'s. Operations for the year resulted in a net profit of $26,000 after a provision for Federal Income and Excess profit taxes of $48,000, a charge for depreciation of $17,000 and officers' bonuses of $53,502. This compares with a net profit the previous year of $18,109. Net sales increased $107,000 to $926,000 and the gross profit margin improved 7.4% to 24.9%. Net Worth increased $26,000 as a result of the net profit.

The balance sheet showed Current Assets of $228,000 to pay Current Liabilities of $129,000 and total liabilities of $202,000. Working Capital increased $22,000 to $99,000 as follows:

FUNDS PROVIDED		FUNDS APPLIED	
Net Profit	$ 26,000.	Incr. Fixed Assets	$ 86,000.
Depreciation	17,000.		
Inc. Term Debt	65,000.	Inc. Working Capital	22,000.
Total Funds Provided	$108,000.	Total Funds Applied	$108,000.

Current Assets of cash $57,000, accounts receivable (net) $81,000, cash value of life insurance $11,000 and inventories $79,000. Cash and receivables totalled $138,000 which was $9,000 more than current liabilities but $64,000 less than total liabilities. Inventory increased $23,000 over the previous year and showed a turnover of 8.8 times to cost of goods sold, compared to 12.1 times the previous year.

The term debt of $73,000 consists of:

(1) $42,000 which is the non-current balance of a term loan we made the company last May. An additional $11,000 is included in current liabilities. It is due in monthly installments of $948 through May, Year A. The loan is guaranteed by Keith A. Williams, James E. Lemon, George R. Jones and Harold J. Adams.

(2) $3,000 which is the non-current balance on equipment purchase contracts. An additional $7,000 is included in current liabilities.

(3) $28,000 of the bonuses paid officers which is being subordinated to our loan. The current liabilities include an additional $25,000 due officers. After being out of our debt since Year G, this company borrowed $9,000 in February of this year on a current basis and repaid it with the proceeds of the term loan. Balances averaged $57,000 in Year F, as compared to $27,000 in Year G.

4-13-Year D
(4 years ago)
F. Norman

Received a copy of the audit report for the fiscal year ended E, containing financial statements as prepared and certified by Hasby Jones & Company, C.P.A.'s. Operations for the year resulted in a net profit of $37,000 after Federal income taxes of $37,000 and a depreciation charge of $26,000. For the previous fiscal year operations resulted in a net profit of $26,000. Sales for the year were $1,206,000, an increase of $280,000 from the previous year's figure of $926,000. The gross profit margin declined 4.7% to 20.2%. Net worth increased $37,000 to $230,000 as a result of net profits.

Current Assets of $242,000 were available to pay Current Liabilities of $118,000 and total liabilities of $178,000. Working Capital increased $25,000 to $124,000 as follows:

ANALYSIS OF CHECKING ACCOUNT

RYAN DIE CASTING COMPANY

		October-Year B	
Average Daily Balance		$ 103,500.00	
Less Average Amount in Transit		19,320.00	
Net Balance		84,180.00	
Less Reserve 21%		17,677.80	
Net Loanable Funds		66,502.20	
Income			
On Loanable Funds at 2-1/2%			$ 138.54
Cost	No. of Items		
Checks on us at .05	512	25.60	
Credit Cost (Deposits) at .12	24	2.88	
City Checks at .026	560	14.56	
Out-of-Town Checks at .026	325	8.45	
Cost of Handling Currency in the Deposits at 60¢ per thousand	10,520	6.31	
Overhead on each account per month - even if the account shows no activity		1.00	
Cost of furnishing printed checks		5.50	
Total Cost			64.30
Profit - (Loss) per month			$ 74.24

Remarks:

Exempt the account from a service charge. Analyze periodically.

CORPORATION COMPARISON
OF STATEMENTS—(Condensed)

Ryan Die Casting Company
1156 E. Beverly St., Chicago

Comparative Figures for Six Years

	(000 OMITTED) TYPE DATE	F EXAM 6 YRS.AGO	E EXAM 5 YRS.AGO	D EXAM 4 YRS.AGO	C EXAM 3 YRS.AGO	B EXAM 2 YRS.AGO	A EXAM 1 YR.AGO
ASSETS	1 CASH	57	62	74	84	162	134
	2 GOVTS & MKT SECURITIES						
	3						
	4 NOTES RECEIVABLE–TRADE						
	5 ACCTS RECEIVABLE–TRADE						
	6 RESERVE FOR BAD DEBTS						
	7 NET RECEIVABLES	81	101	190	229	143	123
	8 INVENTORY (153/158 INCL.)	79	65	93	235	183	143
	9 CASH VALUE LIFE INS	11	14	16	18	23	25
	10						
	11 CURRENT ASSETS	228	242	373	566	511	425
	12						
	13 PREPAID & DEFERRED CHARGES	7	5	4	7	6	8
	14 DUE FROM OFFICERS & EMPL.						
	15 ADV & INVEST–AFFILIATES				53	48	42
	16 OTHER ASSETS						2
	17 FIXED ASSETS	217	237	308	323	328	330
	18 RESERVES FOR DEPRECIATION	57	76	102	129	156	187
	19 NET FIXED ASSETS	160	161	206	194	172	143
	20						
	21						
	22 INTANGIBLES–GOODWILL ETC						
	23 TOTAL ASSETS	395	408	583	820	737	620
LIABILITIES	24 NOTES PAYABLE–BANKS				44	22	
	25 NOTES PAYABLE–OTHER						
	26 ACCOUNTS PAYABLE–TRADE	18	20	41	65	38	44
	27 ACCRUALS	9	11	24	48	34	20
	28 FEDERAL & OTHER TAXES	59	49	58	106	59	35
	29 DUE INDIVIDUALS	25	24	47	59	52	16
	30 CURRENT MATURITY TERM DEBT	18	14	23	24	16	
	31 CURRENT LIABILITIES	129	118	193	346	221	115
	32 LONG TERM DEBT–BANK	45	13	40	16		
	33 LONG TERM DEBT–OTHER						
	34 SUBORDINATED DEBT	28	47	62	70	66	25
	35 TOTAL LIABILITIES	202	178	295	432	287	140
NET WORTH	36						
	37						
	38 SURPLUS RESERVES						
	39 CAPITAL STOCK–PREFERRED						
	40 CAPITAL STOCK–COMMON	44	44	44	44	44	44
	41 TREASURY STOCK (AT COST)						
	42						
	43 CAPITAL SURPLUS						
	44 EARNED SURPLUS	149	186	244	344	406	436
	45 NET WORTH	193	230	288	388	450	480
SUMMARY	46 TOTAL LIAB. & NET WORTH	395	408	583	820	737	620
	47 CURRENT ASSETS	228	242	373	566	511	425
	48 CURRENT LIABILITIES	129	118	193	346	221	115
	49 WORKING CAPITAL	99	124	180	220	290	310
	50 CURRENT RATIO (11 ÷ 31)	1.77	2.05	1.95	1.63	2.32	3.70
	51 QUICK RATIO (1 2 7 ÷ 31)	1.07	1.38	1.37	.91	1.38	2.23
	52 TANGIBLE NET WORTH	193	230	288	388	450	480
	53 WORTH X DEBT (52 ÷ 35)	.96	1.29	.98	.90	1.57	3.42
	54 SALES	926	1,206	1,432	2,159	2,596	1,249
	55 NET PROFIT / LOSS	26	37	57	100	62	30
	56 DIVIDENDS						
	57 INC / DEC WORKING CAPITAL	22	25	56	40	70	20
	58 INC / DEC NET WORTH	26	37	58	100	62	30
	59 CONTINGENT LIABILITIES						

c 8 3

	(000 OMITTED)	F FROM 7 YRS.AGO TO 6 YRS.AGO	E 6 YRS.AGO 5 YRS.AGO	D 5 YRS.AGO 4 YRS.AGO	C 4 YRS.AGO 3 YRS.AGO	B 3 YRS.AGO 2 YRS.AGO	A 2 YRS.AGO 1 YR. AGO
	101 NET SALES	926	1,206	1,432	2,159	2,596	1,249
	102 COST OF SALES	696	963	1,129	1,709	2,240	1,068
	103 GROSS PROFIT	230	243	303	450	356	181
OPERATIONS	104 SELLING & OPERATING EXP						
	105 GENERAL & ADMIN EXP	94	105	102	117	135	106
	106						
	107 PROFIT FROM OPERATIONS	136	138	201	333	221	75
	108						
	109 OTHER INCOME	3	4	7	11	14	12
	110 OTHER EXPENSE	65	68	99	145	117	34
	111						
	112 PROFIT BEFORE TAX	74	74	109	199	118	53
	113 INCOME TAXES	48	37	52	99	56	23
	114						
	115 NET PROFIT AFTER TAX	26	37	57	100	62	30
	116 EARNED SURPLUS—BEGINNING	123	149	186	244	344	406
SURPLUS	117 NET PROFIT/LOSS	26	37	57	100	62	30
	118 DIVIDENDS						
	119 SURPLUS ADJ. NET			1			
	120						
	121						
	122						
	123 EARNED SURPLUS—ENDING	149	186	244	344	406	436
SOURCE & APPLICATION of FUNDS	124 SOURCE OF FUNDS						
	125 NET PROFIT	26	37	57	100	62	30
	126 DEPR. AMORT DEPLETION	17	26	30	39	38	34
	127 INC—TERM DEBT	65		42			
	128						
	129						
	130 OTHER ACCOUNTS—NET		2	1		6	2
	131 SURPLUS ADJUSTMENTS			2			
	132 DECREASE WORKING CAPITAL						
	133 TOTAL	108	65	132	139	106	66
	134 APPLICATION OF FUNDS						
	135 DIVIDENDS PAID						
	136 INVESTED IN FIXED ASSETS	86	27	73	27	16	5
	137 REDUCTION—TERM DEBT		13		16	20	41
	138 INV. IN AFFILIATE				53		
	139						
	140 OTHER ACCOUNTS—NET				3		
	141 SURPLUS ADJUSTMENTS			3			
	142 INCREASE WORKING CAPITAL	22	25	56	40	70	20
	143 TOTAL	108	65	132	139	106	66
	144 % GROSS PROFIT (103 ÷ 101)	24.9%	20.2%	21.1%	20.8%	13.7%	14.5%
	145 % SELL & OPER EXP (104 ÷ 101)	%	%	%	%	%	%
%	146 % GENL & ADM EXP (105 ÷ 101)	10.2%	8.7%	7.1%	5.4%	5.2%	8.5%
	147 % PROFIT BEFORE TAX (112 ÷ 101)	8.0%	6.2%	7.6%	9.2%	4.5%	4.3%
	148 % PROFIT AFTER TAX (115 ÷ 101)	2.8%	3.0%	3.9%	4.6%	2.4%	2.4%
	149 % RECEIVABLES CURRENT	%	%	%	%	%	%
	150						
INVENTORY	151 INV. TURNOVER ON COST OF SALES	14.8	12.2	14.4	10.5	12.2	13.4
	152						
	153 INVENTORY—FINISHED						
	154 INVENTORY—PROCESS	61	40	74	187	125	88
	155 INVENTORY—RAW	18	25	19	48	58	55
	156 INVENTORY—OTHER						
	157 RESERVE FOR INVENTORY						
	158 NET INVENTORY	79	65	93	235	183	143

SPREAD BY

MEMO SHEET

NAME	BUSINESS	ADDRESS
RYAN DIE CASTING CO.	Manufacturer	1156 E. Beverly Street Chicago 49, Illinois

6-13-Year C J. Smith (continued)	Keith requested our permission to pay bonuses of $8,000 to each of the principals, reducing the bonuses owing them. I agreed to this and will have new subordination notes prepared and the present notes cancelled. Keith Williams is still active in managing the company but more and more responsibility is being given to the other three principals. Keith is sure if an accident should happen to him the other three men would be capable of operating the business in the same progressive manner.
9-17-Year C Wallace	Mr. Smith today loaned the above company $44,000 at the rate of 5-1/4% on a plain note basis, due on May 17, Year A.
11-8-Year B G. Keough	Keith Williams called at the bank and reviewed with the writer statements as of and for the fiscal year completed B. Sales for the year totalled $2,596,000, up $500,000 from a year ago. They state a profit of $204,000 before Federal income taxes, officers' bonuses and contributions to the profit sharing trust. After these deductions net profit amounted to $62,000, a yield of 2.4% on net sales. Gross profit fell from 20.8% to 13.7% compared with last year due to increased material costs. The company has not been able to pass the added costs on to their customers. Keith asked our consent to pay officers bonuses of $81,000 for the year. Company has been on our current ledger for more than a year and were in an easy cash position and I told him it would be more prudent to retire the current loans before payment of bonuses. He was agreeable. They will declare bonuses of $81,000 for the fiscal year and technically pay these bonuses and $35,000 of subordinated notes, but they will return $66,000 to the business so that the net cash bonus will be $50,000. The $66,000 will be subordinated to bank debt and they will pay off our current loan in the amount of $22,000. Balance sheet shows a very liquid position with cash, receivables and cash surrender value life insurance (total $307,000) well in excess of current liabilities of $221,000 and total liabilities of $287,000 inclusive of the $66,000 owing to officers. After the action has been completed net worth will amount to $450,000 exclusive of subordinated notes.
12-15-Year A O'Toole	I called here today and in the absence of Keith Williams, President, I visited with Jim Lemon, Vice President, and George Jones, Secretary. Lemon told me volume was down a bit due to lack of large orders but that the die casting business was good, so that results were profitable. Business is operating at a good level with sales of about $79,000 to $87,000 a month. On a volume this size the company should have a profitable year. Both Lemon and Jones expect to be present at our Profit Sharing luncheon to be held shortly. They have an insurance plan now and are of the opinion that they should change to a trusteed plan and will talk this over with us at the luncheon or shortly thereafter. I expressed appreciation for the excellent relationship and the balances they keep on deposit with us.
2-2-Year AA Reagan	Had a nice visit with Jim Lemon, Vice President, and George Jones, Secretary. I discussed the company's profit sharing trust which they will open with us next month.

MEMO SHEET

NAME	BUSINESS	ADDRESS
RYAN DIE CASTING CO.	Manufacturers	1156 E. Beverly Street Chicago 49, Illinois

5-12-Year F O'Toole	The term loan to this company will be dated May 11, with proceeds credited to the company's account. The current note of $10,000 should be charged to their account at this time.
11-25-Year F G. Keough	Today Keith Williams, along with Arthur Peck from the office of Hasby, Jones & Company, the auditing firm employed by the company, called at the bank and reviewed with the writer the preliminary figures for the year ended F. Last year was an excellent one. Based on previous year's percentages, they intend to pay officers' bonuses of $53,000 on a pre-tax profit figure of $127,000. Keith Williams also reported they would require 50% of the amount to pay personal income taxes. They will replace the balance of the bonuses back in the business and subordinate the amount to bank indebtedness. This will increase working capital about $30,000. They have completed their expansion program so working capital at the fiscal year end should amount to $110,000. I told them to write a letter requesting our approval under the term loan note. We will prepare subordination agreements as soon as they send us the required information.
3-15-Year E O'Toole	I called at the company today and had a long and pleasant interview with Keith Williams and the other three principals of the concern. The expansion program, for which we advanced the funds with a term loan, has undoubtedly increased the value of the property and has also supplied the company with more office space and better organization of the plant facilities. Keith Williams informed me that volume continues at a high level and with some new equipment the net profit should show an increase over last year. Their bills are current with plenty of cash in the bank. Keith thanked us for our aid in financing the expansion program.
1-29-Year D G. Maxwell	Keith Williams called at the bank today and requested our aid in acquiring a new 250 ton hydraulic press which will run about $57,000 to $61,000 installed. Keith asked us to rewrite our term loan to $67,000 to be repaid in the same time limit of the present loan. I consented to this. The company may not have need of the funds until about four months so I have provided a commitment letter for 120 days with a fee of 1/2 of 1%.
8-28-Year D G. Maxwell	Today I put through the term loan described in the previous memorandum. Rate is unchanged with covenants substantially the same.
6-13-Year C J. Smith	I called on the company today and had a very pleasant visit with Keith Williams and Jim Lemon. Operations are still running at a high level and they forecast that the fiscal year C will be the best in the history of the company, with volume in the vicinity of $2,500,000 to $2,600,000. I noticed that conditions in the plant are again crowded, even with the expansion program put through in the last few years. Heavy inventory build-ups were made in anticipation of a steel strike. The company has an option to obtain a little plant across the street for $50,000. I told the principals that we would be happy to grant another term loan to help their acquisition. The new 250 ton press has been of substantial help in building volume and improving their profit margin.

MEMO SHEET

NAME	BUSINESS	ADDRESS
RYAN DIE CASTING CO.	Manufacturer	1156 E. Beverly Street Chicago 49, Illinois

9-15-Year G G. Maxwell	Ryan Die Casting Co. is one of our old accounts and is engaged in manufacturing dies against confirmed orders. The company has an excellent reputation and both sales and profits have shown good increases over the years. We think highly of the management and the company's prospects for the next few years appear bright. The company has requested current borrowings to support sale increases and a term loan for plant expansion. We shall be pleased to take care of their requirements. Balances in the account have lately been averaging $30,000.
1-13-Year F J. Smith	Keith Williams called at the bank today and requested a term loan in the approximate amount of $57,000 to replenish working capital which will be expended over the next four or five months in the construction of an addition to their plant. For some time they have owned two of the dwellings bordering their plant on the Northwest, which have now been vacated and torn down and an addition is now in progress. A new space of approximately 5,000 feet will be developed. $44,000 of the $57,000 to be expended represents the general contractor's price and the balance of $13,000 will be spent in heating, wiring, crane facilities, heat treating and other miscellaneous equipment. Their present plant is very overcrowded with the result a great deal of fabricating work has to be contracted to jobbers with a corresponding reduction in profit margin. Williams is sure that with additional space, operating efficiency will be improved and costs lowered. The company continues to operate profitably. Williams reported that volume for the last month was around $87,000, an all time high. Hasby Jones, CPA's are preparing quarterly reports and we will receive copies when they are completed. This is a full loan in relation to the company's working capital but I told Williams we would make it predicated on terms and conditions we would incorporate in the note and we would include the guarantee of the four principals. We will want some restrictions on bonuses being paid the officers. It would be imprudent to stop payment of them, but they can be accrued and then subordinated to bank debt. Williams consented to this and was sure that the company would go along. The new building foundation has been laid and paid for and he does not anticipate a need for the funds for two or three months. We will provide current borrowings if needed to be repaid when the term loan is taken down. One of our officers or myself will call at the plant in the next two or three weeks to discuss term loan covenants with the company.
2-2-Year F B. O Toole	I visited with Keith Williams and the other three principals of the company. The new addition is well underway. Operations are on a high level with the building pressed for space and turnout clearly inefficient. We are drawing up the term loan note for $57,000 even though the company may not draw down the funds for two or three months.
4-9-Year F G. Maxwell	Keith Williams called today to advise us about their plant expansion. He picked up the $57,000 term loan note. They have decided to install a new overhead crane for material handling and a heat treating unit which will cost about $6,000. Keith informed me they were in an easy cash position with balances about $35,000 after paying all their trade bills on a discount basis. Williams expects a high level of operations until this summer. Business is running at an all time high. Keith expects to put through his term loan about the second week in May.

CS 18

MEMO SHEET

NAME BUSINESS ADDRESS

THE RYAN DIE CASTING CO.

IN RE ABOVE NEW ACCOUNT THE RECORDS INDICATE YOU INTRODUCED OR ARRANGED FOR SAME. KINDLY FURNISH HEREON FOR THE COMPLETION OF THE FILE ALL THE INFORMATION YOU CAN GET ON THE SUBJECT

7-31-Year F
T.F.J.

The Ryan Die Casting Co. was introduced to us by Mr. John Adamson, President and principal stockholder of the Jones Manufacturing Company. Mr. Adamson has known both Mr. Williams and Mr. Lemon for a number of years and regards them as outstanding men of integrity with a number of years experience in this line of business.

CS 18

MEMO SHEET

NAME	BUSINESS	ADDRESS
RYAN DIE CASTING CO.	Manufacturer	1156 E. Beverly St. Chicago 49, Ill.

3-28-Year C	Letter to Keith Williams, President: "In the temporary absence of Mr. Keough this will acknowledge receipt of your letter dated March 27, enclosing financial statement of Ryan Die Casting Co., as of December 31, Year D. We appreciate having these statements for our files and they will be referred to Mr. Keough upon his return to the bank next Monday."
4-16-Year C	Letter to Harold J. Adams, Treasurer: "In accordance with our discussion yesterday, we have charged your account for the ninety-day note. The paid note, duly cancelled, is enclosed for your records, together with our covering advice. Would you kindly sign a copy of this letter as receipt for the above document. Best regards."
12-26-Year B	Letter from Harold Adams, Treasurer: "I am enclosing a note for $50,000. Income tax payments of over $55,000, bonuses to employees and payments for our new crane are taxing our bank balance heavily. Let me know if you have any questions."
12-27-Year B	*Letter to Harold Adams, Treasurer. "We acknowledge receipt of your* letter of December 26, enclosing your company's note in the amount of $50,000 which we have discounted today and our advice of credit is enclosed. Best regards."
2-15-Year A	Letter from Keith Williams, President: "As you will note from our audited statements of December 31, Year B, we have exceeded the limitation of our term loan agreement in regard to fixed assets additions. The limitation on fixed assets was $50,000. We exceeded this limitation by $4,674.83. We will appreciate your cooperation in covering these deviations in the best manner possible."
2-16-Year A	Letter to Keith Williams, President: "We have for acknowledgement your letter of February 15, advising us that your audited statements for the fiscal year ended December 31, Year B, reflect that you have exceeded the limitation in the term loan agreement and requesting our consent to expenditures for fixed assets in the sum of $54,674.83. We hereby give our consent to the foregoing with the understanding that except as here provided the term loan remains in full force and effect."

CS 11

MEMO SHEET

NAME	BUSINESS	ADDRESS
RYAN DIE CASTING CO.	Manufacturer	1156 E. Beverly St. Chicago 49, Ill.

1-15-Year E	Letter from Harold Sams, attorney: "I have, and enclose herewith, a short history of the Ryan Die Casting Company, which I think you will find interesting."
4-23-Year C	Copy of letter from Keith Williams to National Bank, St. Louis, Missouri, and sent to us by Keith Williams: "We are pleased to note that you have agreed to extend our company a $50,000 line of credit for the present year. We appreciate your desire to be of service."

CS

MEMO SHEET

NAME	BUSINESS	ADDRESS
RYAN DIE CASTING CO.	Manufacturer	1156 E. Beverly St. Chicago 49, Illinois

9-14-Year F J.S.M. (continued)	Industrial Milling Machines, Inc.: "For your files we are pleased to say that the high credit we have extended the above account during the past year has been $5,000, and at the present time nothing is owing. Their bills have always been paid within our discount terms and we consider the account as being very desirable."
8-23-Year C	Mr. Peters, Credit Department, National Bank of St. Louis: "I should like to make a mutual checking with you on this name as they are coming in today for $40,000 and have not been out of our debt for a full month yet. The company gave us a clean up in the middle of July, after being in our debt since last October and they used as high as $50,000, although they were only owing us $25,000 from March on. Balances have averaged about $14,000 the past year and we have no complaint to make of the manner in which they have handled their affairs here. We continue to have confidence in his ability and integrity and will go along as we have in the past. Our regular line to the company is $50,000 but we would not hesitate to go higher. We obtain the endorsement of Mr. Williams on paper. We have not obtained a trade checking this year but they still anticipate and discount their bills."
12-21-Year A	Called Mr. Peters, Credit Department, National Bank of St. Louis in order to bring our records up to date. Mr Peters emphasized previous favorable relations with this company. The experience of the National Bank has been as follows: "Line of credit remains at $50,000 on the endorsement of Mr. Williams. Company was out of debt until November when they came in for $50,000, which is presently owing. Balances for the past year averaged around $15,000. Periodic investigations in trade quarters have shown high credits of $17,000 with payments invariably retired on a discount basis. Last trade checking was made about two months ago. The account is still a very desirable one."

CSH

MEMO SHEET

NAME	BUSINESS	ADDRESS
RYAN DIE CASTING CO.	Manufacturer	1156 E Beverly St. Chicago 49, Ill.

9-14-Year F
J.S.M.

Dun & Bradstreet: "We have an up-to-date report on this company and it contains statements for the past three years, including the balance sheet of last December 31. We have no current trade checking but previous reports show the company anticipates and discounts. We will send you a copy of a current trade checking as soon as an investigation is made."

Mr. Peters, Credit Department, National Bank of St. Louis: "This account opened with us about ten years ago. The account has been very satisfactory with balances averaging low five figure amounts. Balances so far this year are averaging around $15,000. We have loaned them on an unsecured basis with satisfactory results, supported by the endorsement of the President of the company. His net worth is nominal. We do not have any later statement figures than December 31, and we do not have a late detailed trade checking. The December 31, statement according to our analysis shows a tangible net worth of $193,000, consisting of common stock of $44,000 and surplus of $149,000. Current assets of $228,000 were available to pay current liabilities of $129,000 resulting in a working capital of $99,000. Comparative statements reveal consistent increases in net worth and working capital. Operations last year resulted in a net profit of $26,000 on a sales volume of $926,000. Earnings are retained in the business.

In the event you care to contact their suppliers, they have been doing business with the following concerns: Hi-Test Steel Company, Rite-Way Crane Co., Central Lathe Works, Reliable Forgings, Inc., General Tools, Inc., and Industrial Milling Machines, Inc."

Hi-Test Steel Company: "We have been doing business with this concern for several years and have not hesitated to grant them credit up to $15,000 on sixty day terms. They discount their bills and we have a high regard for the company."

Rite-Way Crane Co.: "We have been doing business with this concern for the past two years, the highest credit extended being about $10,000 and bills are paid promptly on sixty day terms. At the present time they are owing us about $7,000 which is not due. They are discounting their bills with us."

Central Lathe Works: "These people are well known in the trade and have no trouble in securing credit for their requirements. Our account has never run over $4,000 although we would gladly go higher than that as they discount their bills."

Reliable Forgings, Inc.: "This is a very good account and they always discount their bills. They are not owing us at this time but in the past we have sold them as high as $10,000. The principals in our opinion are aggressive. They never miss a discount with us."

General Tools, Inc.: "We have sold the company for years and have a high regard for the principals. We do not hesitate to sell them up to $15,000 or $16,000. Bills are discounted. They owe us only $1,500 at present."

CSM

MEMO SHEET

NAME	BUSINESS	ADDRESS
RYAN DIE CASTING CO.	Dies	1156 E. Beverly St. Chicago 49, Illinois

Dun & Bradstreet ANALYTICAL Report

SIC | NAME & ADDRESS | STARTED | RATING UNCHANGED

33 23 A-AD 2 MAY 16 19-- N 1928 B + 1

RYAN DIE CASTING COMPANY (INC) MNFR

1156 E BEVERLY ST
CHICAGO 49 ILLINOIS

TRADE	DISC-PPT
SALES	$1,249,000
WORTH	$480,000
EMPLOYS	136

SUMMARY

VOLUME OF THIS ESTABLISHED PRODUCER OF STEEL CASTINGS DROPPED 50% LAST YEAR DUE TO UNSETTLED LABOR CONDITIONS IN THE INDUSTRY. EXPENSES WERE REDUCED AND OPERATIONS REMAINED PROFITABLE. SALES TREND SO FAR THIS YEAR CONTINUES DOWNWARD, BUT OPERATIONS ARE ON A PROFITABLE BASIS AND FINANCIAL CONDITION IS LIQUID.

TRADE

HC	OWE	TERMS	MAY 12 19--	SOLD
4000		1-10-30	Disc	Over 3 yrs
2800	1000	2-10-30	Disc	Over 3 yrs
600		2-10-30	Disc	Over 3 yrs
100	100	1-10-30	Disc-ppt	2 yrs
9000	2000	Net 60	Ppt	Over 3 yrs to date
8000	3000	Net 60	Ppt	Over 3 yrs to date
9000	Curr	60 days	Ppt	Over 3 yrs
3600	2000	30	Ppt	Over 3 yrs
1000	1000	Net	First Sale	

BANKING

Accounts are maintained at one local bank and at one in St. Louis, Mo. Loans for current and for long term purposes have been granted on the straight unsecured note of the corporation. Borrowings have been handled as agreed. All loans were cleaned up before the last statement date and there have been no requests for accommodation since.

CURRENT

On May 13, 19--, H. J. Adams, Treasurer, stated that sales for the first four months of the current year decreased about 35% compared with the same period of last year, but that operations have continued profitable due to the fact that production and shipments have been against firm contracts. He said that production outlook for the next few months was not too favorable, since backlog of unfilled orders was at the lowest level for the past several years. In order to diversify, management is considering the possibility of adding aluminum and alloy castings to its line.

At the present time inventory is approximately $120,000, largely in raw materials, and accounts payable are about $20,000. Due to the restriction in production and shipments, there has been no recent need for long or short-term borrowings. Cash position continues strong with balances totalling in excess of $100,000. Adams is expecting a pickup in regular orders as soon as customers re-tool for their new models and is optimistic about the last half of the year.
5 16 -- (744 1)

PLEASE NOTE WHETHER NAME, BUSINESS AND STREET ADDRESS CORRESPOND WITH YOUR INQUIRY.
The foregoing report is furnished at your request, under your Subscription Contract in STRICT CONFIDENCE, by DUN & BRADSTREET, Inc. as your agents and employees for your exclusive use as an aid in determining the advisability of granting credit or insurance and for no other purpose. 8R6 1 (30466)

Figures prepared from statements signed by H. J. Adams, Treas. Accountants: Hasby, Jones & Co., CPA's, Chicago.

	FINANCIAL STATEMENTS		
	(C) Three Years Ago	(B) Two Years Ago	(A) One Year Ago
Cash	$ 84,000	$ 162,000	$ 134,000
Accounts Receivable	229,000	143,000	123,000
Inventory	235,000	183,000	143,000
TOTAL CURRENT ASSETS	548,000	488,000	400,000
Land	10,000	10,000	10,000
Other Fixed Assets	184,000	162,000	133,000
Cash Sur. Life Ins.	18,000	23,000	25,000
Misc. Receivables	---	---	2,000
Deferred Charges	7,000	6,000	8,000
Invest. & Adv. Affil.	53,000	48,000	42,000
TOTAL ASSETS	$ 820,000	$ 737,000	$ 620,000
Due Banks	44,000	22,000	---
Accounts Payable	65,000	38,000	44,000
Federal Income Taxes	99,000	56,000	23,000
Other Income Taxes	7,000	3,000	12,000
Accrued Liabilities	48,000	34,000	20,000
Due Off. & Stkhldrs.-Current	59,000	52,000	16,000
Term Loan To Bank-Current	24,000	16,000	---
TOTAL CURRENT LIABILITIES	346,000	221,000	115,000
Due Officers-Subordinated	70,000	66,000	25,000
Term Loan To Bank	16,000	---	---
Common Stock	44,000	44,000	44,000
Earned Surplus	344,000	406,000	436,000
TOTAL LIABILITIES	$ 820,000	$ 737,000	$ 620,000
NET WORKING CAPITAL	$ 202,000	$ 267,000	$ 285,000
CURRENT RATIO	1.58	2.21	3.48
TANGIBLE NET WORTH	$ 388,000	$ 450,000	$ 480,000

Inventory valued at the lower of cost or market. Accounts receivable are less reserves of $2,000 for bad debts. Machinery, fixtures and equipment are less reserves of $165,000 for depreciation. Fire insurance on inventory $200,000; on buildings $125,000; on machinery and equipment $250,000. No contingent debt reported.
5 16 --

(CONTINUED)

INCOME STATEMENTS AND SURPLUS RECONCILIATIONS

	(C) Three Years Ago	(B) Two Years Ago	(A) One Year Ago
NET SALES	$2,159,000	$2,596,000	$1,249,000
Cost of Goods Sold	1,709,000	2,240,000	1,068,000
GROSS PROFIT ON SALES	450,000	356,000	181,000
EXPENSES			
Selling Administrative	117,000	135,000	106,000
OTHER INCOME	11,000	14,000	12,000
OTHER EXPENSES	145,000	117,000	34,000
NET INCOME BEFORE TAXES	199,000	118,000	53,000
Federal Income Taxes	99,000	56,000	23,000
NET INCOME AFTER TAXES	$ 100,000	$ 62,000	$ 30,000
SURPLUS AT START	$ 244,000	$ 344,000	$ 406,000
Net Income	100,000	62,000	30,000
SURPLUS AT END	$ 344,000	$ 406,000	$ 436,000

ANALYSIS The volume of this business is primarily dependent on production in the automotive and appliance industries. Net sales increased 20% between Year (C) and Year (B), but dropped slightly more than 50% during Year (A) due to a slump in automobile manufacturing which was brought about by a steel strike. Nevertheless through good management a well balanced financial condition was maintained and operations were kept on a profitable basis. Net Working Capital and Tangible Net Worth have shown consistent expansion as no dividends have been declared or paid.

Cash flow has been sufficient to permit item Due Officers & Stockholders - Current, consisting of accumulated bonuses, to be reduced substantially, the current bank debt to be cleaned up, the deferred item Due Officers-Subordinated to be reduced from $70,000 to $25,000, and the Term Loan to Bank to be liquidated completely. At the same time other current debts comprised of accounts payable, accrued liabilities, and taxes have been retired when due.

Deferred item Due Officers-Subordinated consists of non-interest bearing, unsecured notes due more than one year from last statement date. These notes, also represented by deferred bonuses, have been subordinated to any existing current and term bank loans.

Investments & Advances Affiliate $42,000 at the close of Year (A) consisted of $35,000 capital stock, representing a 30% interest at cost in R-D-C Tool Co., Inc. which is described under History in this report, and merchandise advances $7,000 on regular trade terms.

OPERATION Products: Manufactures against direct order steel die castings (90%) and does some assembling (10%).
Distribution: Sales to manufacturers in the automotive, aircraft, farm equipment and appliance industries.
Territory: The entire United States
Accounts: 150
Terms: 1% 10 days net 30

(CONTINUED)

OPERATION (Continued) Seasons: There are no pronounced seasonal aspects, but production and shipments are dependent upon seasonal variations experienced by customers.
Employees: 125 production; 6 office; 5 salesmen.
Facilities: Owns a one-story, brick, concrete and steel factory type structure 200 by 300 feet which houses plant, tool shop and offices. Equipment is of late design and includes a 250 ton hydraulic press, power presses, trimming machines, cranes, and finishing tools.

MANAGEMENT Keith A. Williams, Pres. James E. Lemon, V Pres.
George R. Jones, Sec. Harold J. Adams, Treas.
Directors: Harold J. Adams, Bert B. Bell, James E. Lemon, and Keith A. Williams.

HISTORY Started: 1928 as a partnership of Walter C. Ryan and Keith A. Williams.
Incorporated: Illinois May 17, 1930.
Authorized Capital Stock: 500 shares Common $10 par value.
Outstanding Capital Stock: 4400 shares; 1500 shares owned by Williams, 1500 by Lemon, 1000 by Adams, 300 by Jones.

Williams born 1902, married, graduate of Purdue 1925. Employed as a draftsman by Mid-West Die Casters, Chicago 1925-1928. Has the general supervision of the business. Life insured for $100,000, business the beneficiary. Williams also President of R-D-C Tool Co., Inc., which is described in a following paragraph.

Lemon, born 1912, married, graduate of University of Iowa 1935. Employed by this business 1935, elected Vice President 1940, since 1946 has been in charge of sales. Life insured for $50,000, business the beneficiary.

Jones, born 1919, married. 1938-1942 employed in trust department of State Bank & Trust Co., 1942-1945 served in U.S. Air Force; 1945-1949 employed in production department of Empire Electronics, Davenport, Iowa; with Ryan Die Casting Company (Inc) since 1949, elected Secretary 1955. Is office manager.

Adams, born 1906, married, graduate of Rutgers 1929. With this business in various capacities since its incorporation in 1930. Was elected Treasurer in 1951 following the death of Walter C. Ryan. Is in charge of finances. Life insured for $50,000, business the beneficiary. Is Vice President of R-D-C Tool Co., Inc.

Bell, who owns 100 shares of stock, is a partner in the law firm of Bell & Burdick, Chicago.

Through inter-locking personnel and a 30% capital stock interest, Ryan Die Casting Company (Inc) is affiliated with R-D-C Tool Co., Inc., manufacturer precision gauges for the automotive and aircraft industries, Detroit, Michigan. That concern was formed in 1948. At Year (A), R-D-C Tool Co., Inc., had a tangible net worth of $165,775 and was in a satisfactory financial condition. Aside from occasional merchandise advances on 30 day terms from the subject to R-D-C Tool Co., Inc., there are no other inter-company transactions such as cash advances, loans, guarantees, or endorsements between the two concerns.
5 16 -- (744 1)

CS 5 (Please attach detailed schedules if lines provided are inadequate)

To THE FIRST NATIONAL BANK OF CHICAGO

Name (Corporate style under charter) RYAN DIE CASTING COMPANY

Business Metal Dies

Location 1156 E. Beverly St., Chicago Branches

For the purpose of obtaining credit, from time to time, from the above bank for our negotiable paper, or otherwise, the undersigned furnishes the following statement of condition as of the 31st day of December, 19--, and the undersigned agrees and guarantees that said statement and all other information herein furnished is in all respects true and correct.

Fill all blanks, writing "no" or "none" where necessary to complete information.

ASSETS		
Cash on hand and in banks,		134,000.00
Cash advances on purchases,		
Notes receivable of customers, good,	$	
Less reserve,		
Accounts receivable of customers, good,	$ 125,000.00	
Less reserve,	2,000.00	123,000.00
Trade or bank acceptances,		
Inventory finished, (how valued)	$	
Inventory in process, (how valued)		
Raw material, (how valued)		
Merchandise consigned out, (how valued)		
Total inventory	$	
Less reserves,		143,000.00
United States Government Securities,		
Other Securities listed on Exchanges,		
Cash surrender value life insurance,		25,000.00
Other current assets and of what composed.		
Total current assets,		425,000.00
Securities not listed on Exchanges,		
Investments in and advances to affiliates,		42,000.00
Notes and accounts receivable of customers, doubtful,	$	
Less reserve,		
Notes and accounts receivable, due from officers and stockholders,		
Advances to salesmen and employees,		
Notes and accounts receivable, due from employees,		
Loans, due from others,		
Land,		10,000.00
Buildings,	$ 75,000.00	
Less depreciation reserve,	32,000.00	53,000.00
Machinery fixtures, and equipment,	$ 245,000.00	
Less depreciation reserve,	165,000.00	80,000.00
Real Estate not used in business,		
Deferred charges,		8,000.00
Treasury stock, Preferred		
Treasury stock, Common		
Good will, patents, trade-marks, etc.,		
Other assets and of what composed		
Miscellaneous Receivables		2,000.00
TOTAL ASSETS,		620,000.00

LIABILITIES		
Notes payable to banks, —Unsecured,		
" " " " —Secured,		
Notes payable for merchandise,		
Notes payable to others,		
Trade or bank acceptances,		
Accounts payable, not due,		44,000.00
Accounts payable, past due,		
Advances by customers,		
Bank overdrafts,		
Dividends declared, but unpaid,		
Federal income taxes,		23,000.00
Other than Federal income taxes,		12,000.00
Accrued liabilities,		20,000.00
Due Officers and Stockholders,		16,000.00
Deposits of money with company		
Bonds or mortgages due within 12 months,		
Chattel mortgage notes due within 12 months,		
Other current liabilities and of what composed		
Total current liabilities,		115,000.00
Bonds or mortgages due after 12 months,		
Chattel mortgage notes due after 12 months,		
Other liabilities and of what composed		
Due Officers - Subordinated		25,000.00
Total indebtedness,		140,000.00
Capital stock, preferred (Par value $)		
Authorized,	$	
Unissued,		
Capital stock, common (Par value $ 10.00)		
Authorized,	$ 50,000.00	
Unissued,	6,000.00	44,000.00
Capital stock, no par value (Number of shares outstanding,)		
Capital surplus,		
Earned surplus,		436,000.00
Reserves and contingent accounts,		
TOTAL LIABILITIES,		620,000.00

PROFIT AND LOSS STATEMENT

For the period ______ (date) to ______ (date)

			%
Gross Sales		1 251,000.00	
Less—Returns, allowances, etc.		2,000.00	
Net Sales		1 249,000.00	100.0
Cost of Goods Sold:			
Inventory at beginning of period $	183,000.00		
Add—Purchases	3[illegible],000.00		
Mfg. Expense	720,000.00		
	1,211,000.00		
Less—Inventory at close	[illegible]3,000.00	1 063,000.00	
Gross Profit or Loss on Sales		181,000.00	14.5
Selling Expenses $			
Administrative Expenses $			
Total Selling and Administrative Expenses		106,000.00	3 5
Net Profit or Loss from Operations (forwarded)		75,000.00	4 3

(Note—State total amount of depreciation charged during period reflected in above $ 34,000.00)

		%
Net Profit or Loss from Operations (brought forward)	75,000.00	
Add—Other Income: $	12,000.00	
	87,000.00	
Deduct—Other Expenses $	34,000.00	
Net Profit before Federal Taxes	53,000.00	
Less— $	23,000.00	
Net Profit or Loss for Period	30,000.00	

Reconciliation of Surplus

Surplus at Beginning of Period		406,000.00
Add—Net Profits	$30,000.00	
Other Additions		30,000.00
Less—Dividends	$	
Other Deductions		
Surplus at the Statement Date		436,000.00

Please give full particulars regarding other additions or deductions ______

UNITED STATES GOVERNMENT AND OTHER SECURITIES

DESCRIPTION	NO. OF SHARES	PAR AMOUNT	MARKET VALUE	VALUATION USED IN STATEMENT

LAND AND BUILDINGS

DESCRIPTION AND LOCATION	TITLE IN NAME OF	APPRAISED VALUE	BOOK VALUE	MORTGAGES
Single story—brick—concrete and steel	Company	125,000.00	63,000.00	None

DIVIDEND RECORD	PREFERRED STOCK	COMMON STOCK	NO PAR VALUE STOCK
Annual dividend rates			
Give dates and rates or amounts of (1) dividends paid during period covered by this statement			
(2) dividends declared and/or paid since date of this statement			

Give callable features, restrictions, or special provisions of Preferred or other classes of stock ______

Was treasury stock acquired for cash? __________ If not, what was consideration __________

Give details of sinking fund provisions and payment requirements of bonds and mortgages __________

Company incorporated in State of Illinois Date of Charter 5/17/30 Commenced business 1/4/31

To what date have your records been examined and approved by the Internal Revenue Department? __________

On what date does your fiscal year close? December 31

Are your books and records regularly audited by Certified Public Accountants? Yes (If so, by whom?) Hasby Jones & Company

Fiscal date of last audit __________

Regular time of taking inventory December 31 Basis taken, cost ("C") or cost or market whichever lower ("C or M") or last in first out ("L. I. F. O.") C or M

Is statement based on actual or estimated inventory? Actual By whom taken or made? Officers date Dec. 31

By whom was this statement compiled? Harold J. Adams ; his (or her) position Treasurer

Average amount of inventory carried, $ 180,000.00 Are you fully insured under 80% clause? Yes

Amount of fire insurance on inventory, $ 200,000.00 ; on buildings, $ 125,000.00 ; on machinery and tools, $ 250,000.00

Give particulars and amount of other insurance carried __________

Are goods shipped to branches, selling companies or other agencies carried on books in inventory or accounts receivable? No

Do you receive merchandise on consignment? No If so, give particulars __________

What are your regular selling terms? 1% 10 days, net 30

Are any of your assets pledged as security for loans, advances or other Liabilities? No If so, give particulars __________

Are any of your accounts or notes payable otherwise secured? No If so, give particulars __________

Are there any suits pending against your corporation? No If so, give particulars __________

Explain the source of the Capital Surplus Account __________

Give particulars regarding Reserve and Contingent accounts __________

Have you any Contingent Liabilities for

- Bills, Accounts, Notes, or Acceptances pledged or discounted? __________ $ __________
- Accommodation paper or endorsements for others? __________ $ __________
- Purchase commitments? __________ $ __________
- Guarantee of stocks, bonds or mortgages? __________ $ __________
- Litigation in process or threatened? __________ $ __________
- Additional Taxes? __________ $ __________
- Any other reason? __________ $ __________

Classify Accounts Receivable of customers, good, as follows:

Not due	$
1 to 30 days past due	$
31 to 60 days past due	$
61 to 90 days past due	$
91 to 180 days past due	$
181 days or more past due	$
Total	$

Classify Notes Receivable of customers, good, as follows:

Not due	$
Past due	$
Extended or renewed	$
Total	$

Do any of the accounts or notes receivable represent amounts due from affiliates? __________ If so, give particulars __________

State amount charged off for bad debts during period under review, $ 1,200.00 Amount recovered during same period, $ 300.00

What amount of accounts and/or notes receivable have a maturity exceeding one year from statement date? Current Assets $ __________ Deferred Assets $ __________

State maximum amount current indebtedness during last fiscal year, Borrowed Money $ __________ Date __________ Other $ __________ Date __________

State minimum amount current indebtedness during last fiscal year, $ __________ Date __________ $ __________ Date __________

Do your plans for the current year contemplate any building program, plant extension or investment in other fixed assets? __________ If so, state amount to be invested, $ __________ Purpose __________

We believe the maximum aggregate amount which we shall borrow on short credit or sale of notes during the current year will not exceed $ __________ and we hereby agree to obtain this bank's consent before borrowing in excess of that amount.

	OFFICERS—Name in Full	No. of Shares Held Pfd.	No. of Shares Held Com.	ADDRESS
President	Keith A. Williams		1,500	Elmhurst, Illinois
Vice-President	James E. Lemon		1,500	Chicago, Illinois
Vice-President				
Secretary	George R. Jones		300	Chicago, Illinois
Treasurer	Harold J. Adams		1,000	LaGrange, Illinois

DIRECTORS—Name in Full	No. of Shares Held Pfd.	No. of Shares Held Com.	ADDRESS
Keith A Williams		1,500	Elmhurst, Illinois
James E. Lemon		1,500	Chicago, Illinois
Harold J. Adams		1,000	LaGrange, Illinois
Bert B. Bell		100	Chicago, Illinois

[illegible]

Name	Line of Credit	Amount in Use	Date
National Bank, St. Louis, Mo.	$ None	$	
	$	$	
	$	$	
	$	$	

Names of mercantile houses from which principal purchases are made: LOCATION

U. S. Steel Company	Chicago, Illinois
Acme Steel Company	" "
Inland Steel Company	" "

Do you receive any special terms or datings? ______ If so, from whom and on what basis? ______

Do you give notes or trade acceptances for merchandise? ______ If so, give particulars ______

Do you discount or anticipate all your bills? ______

Impress Corporate Seal Here

Date January 29, 19__

(Corporate name) Ryan Die Casting Company

By Harold J. Adams

Title Treasurer

STATE OF Illinois
COUNTY OF Cook } ss.

I, Harold J. Adams, being duly sworn, on oath depose and say that I am Treasurer of Ryan Die Casting Company that I have read and know the contents of the foregoing statement by me subscribed; that I signed the foregoing statement for and in behalf of said company and that the statement, and all information contained [illegible], is true and correct, to the best of my knowledge and belief.

Harold J. Adams

Subscribed and sworn to before me

this 29th day of January 19__

Norbert B Smith

Notary Public

M 177

CONTACT RECORD

NAME	BUSINESS	ADDRESS
RYAN DIE CASTING CO.	Manufacturer	1156 E. Beverly St. Chicago 49, Ill.

12-5-Year E J. Smith	Called today and found the company very busy. Mr. Williams said sales volume was up for the year. The company will show a good profit this year. Keith Williams is adding extra men to keep up with the increased demand. He is very optimistic about the future.
6-18-Year C G. Keough	I had a pleasant visit with Keith Williams, President, and George Jones, Secretary. Mr. Williams told me our services had been most satisfactory. He has a very high regard for our services and commends the bank to his friends whenever the occasion arises. Sales are still increasing and prospects remain bright. Both men expressed appreciation for the call.
9-6-Year C J. Smith	I stopped in to see Keith Williams who was out for the day. I left my card with his secretary and asked that he be informed of the nature of my call.
11-19-Year A	I called on the company today and had a nice visit with Keith Williams, President, and George Jones, Secretary. Mr. Williams said the company would show an excellent profit but a little below last year. Sales are at an all time high and they intend to increase bonuses. They intend to pay off bank indebtedness in sixty days.
7-6-Year AA F. Bolden	Called on the company today and visited with Mr. Williams. He said sales are way off but he will show a good profit because of profitable contracts.

UNIVERSITY OF JODHPUR
Acces
Date
CENTRAL LIBRARY, JODHPUR

REPLIES TO INQUIRIES

NAME Ryan Die Casting Company

DATE OF INQUIRY	FROM	ADDRESS	DATE OF REPLY	FROM
1-26-Year E	Manufacturer's Trust Company	New York City	1-28-Year E	
2-15-Year D	Dun & Bradstreet, Inc.	Chicago, Illinois	2-15-Year D	
6-8-Year C	National Bank	St. Louis	6-9-Year C	
11-21-Year B	General Forgings	Chicago, Illinois	11-23-Year B	
3-15-Year A	Hi-Speed Machinery Co.	Chicago, Illinois	3-16-Year A	
5-18-Year A	Bank of London	London	5-18-Year A	
9-13-Year A	City National Bank	Baton Rouge, Louisiana	9-15-Year A	
11-13-Year A	General Tools, Inc.	Milwaukee, Wis.	11-14-Year A	

chapter II

DESCRIPTION OF A TYPICAL BANK CREDIT FILE

THE MOST ESSENTIAL RECORD IN THE CREDIT DEPARTMENT OF A banking institution is the credit file, or, as it is also called, the credit folder Without the information that the credit file contains, there could be no credit department worthy of the name In a compact form this file holds all the pertinent facts required by a loan officer to pass intelligent judgment upon a credit risk A typical bank credit file is reproduced between Chapters I and II The sources and the arrangement of information and the forms contained in a typical bank credit file are described in this chapter

Probably no two bank credit departments prepare their credit files or their auxiliary records on exactly the same basis Nor is there any such thing as a perfect filing and record system suitable for all banks in all situations The officer in charge of the credit department invariably modifies the system of filing and keeping records from time to time to meet the ever changing needs of his particular bank The active credit file must, however, be kept up to date, complete in every respect, and readily accessible No situation is quite so exasperating to either a depositor or a bank officer as to have an application for a line of credit held up because of a misplaced credit file

Credit files may vary not only from bank to bank but also within a particular bank A bank, for example, may use a more expensive cover for the files of its customers than for those of its non-customers, because the latter are ordinarily handled less The outside cover on a customer's file may be heavy pressboard cardboard, or fiberboard, it may be slightly larger than letter size and may open like a book The file for a non customer may simply have a regular manila cover The outside covers

may be of different colors, such as green for correspondent bank accounts, and gray, blue, or maroon for commercial accounts. The customer's name is invariably placed on the protruding edge of the rear cover.

Credit folders ordinarily are kept alphabetically in filing cabinets, except that correspondent banks generally are filed geographically by cities, because so many banking institutions have similar names. Folders on foreign names likewise are generally filed geographically. Folders of non-customer accounts are often filed separately from customer accounts.

CONTENTS OF THE CREDIT FOLDER

As a rule each credit folder is divided into several sections, separated by index sheets of stiff paper. Each section contains a specific type of data, such as memoranda by the officer, financial statements, correspondence with the borrower, other correspondence, bank and trade checkings, clippings and circulars, and commercial agency reports. In case the folder is not divided in this manner, the information is placed in a uniform order in each folder so that any specific information may easily be located. The particular credit file illustrated between Chapters I and II is divided into nine sections, which are separated by eight index sheets into the following types of credit information:

1. Summarized information
   a. History sheet
   b. Record of overdrafts and returned checks
   c. Bank officer's annual report
   d. Account analysis form
2. Statement comparison
3. Memoranda and interviews
   a. Recent memoranda
   b. Memo sheet on the opening of the account
4. Direct correspondence
5. Other correspondence
6. Investigations
   a. Bank checkings
   b. Trade checkings
7. Clippings and circulars
8. Financial statements and mercantile agency reports
9. Contacts
   a. Interviews with officials of the concern
   b. Replies to inquiries

If reference is made to the illustrated credit file, the explanations that follow will be more readily comprehended Notice particularly that, where there are two or three pages in a section, page two is on top of page one and page three is on top of page two, instead of following each other in numerical order This method of arrangement is followed so that the latest information will always be on top Notice also that the information reads from the bottom of the file up All pages are 8½ by 11 inches, the standard size of a business letterhead Most pages also have wide margins at the left, in which are placed the dates of interviews and correspondence, and in the case of interviews and investigations, the initials of the bank officer or the credit investigator who obtained the information and put it in the credit file

Summarized Information

The first three or four pages in most credit folders contain summarized information that the banker desires to have readily available In the typical credit file this information is separated into four distinct parts, which are described in the following paragraphs.

History Sheet—The history sheet is really the flyleaf of the credit folder This sheet gives the customer's name, address, and line of business, the date when the account was opened, the initials of the bank officer who accepted the account, and, if the concern is incorporated, the names of its officials and their titles If possible, the name of the person who introduced the customer to the bank is also noted, as he may be a source of credit information and otherwise helpful in future relations with the new customer

The record of relationships with other departments shows to what extent the customer may from time to time be using the different facilities of the bank This information indicates potential opportunities for additional business and is extremely valuable in the case of a large bank, with such varied facilities as a bond department, a trust department, a travel bureau, a savings department, safe deposit vaults, and an international banking department.

When a customer's note bears an endorsement or guaranty, the names of the endorsers or guarantors are recorded on this same sheet for ready reference In this way the information is readily available without sending to the discount department for the note itself. The other bank connections of the customer are also recorded here, up-to-date information which is essential in order to make regular checkings with them, particularly in the case of borrowing accounts

The various related accounts to which the bank may have loaned money are then recorded on this sheet so that the bank officer will have before him a picture of all of the cuostomer's activities and will not extend too large a volume of loans in the aggregate to the same general interests.

Toward the bottom of this sheet is the printed word "Basis," which simply indicates the service charge, if any, to be placed on the account. The method of arriving at this charge is explained more fully in connection with the account analysis form, which follows in the credit file. Finally, there is a space for remarks that a bank officer might consider of sufficient importance for recording on the first sheet of the credit file.

Record of Overdrafts and Returned Checks.—This second sheet in the credit file is important whenever the bank must return checks drawn against insufficient balances or against uncollected funds. A bank can hardly be expected to disburse funds that it has not had time to collect. The record indicates the date each check is returned, the amount of the check, and the reason for its return.

This sheet is also used to record checks that are actually paid by the bank when an account is overdrawn. The customer may have other accounts, or he may have made an error in his records. If the bank is satisfied regarding his integrity and his financial worth, it may permit an occasional overdraft, but no bank looks upon the practice with favor and ordinarily will request that an account be closed if the customer consistently overdraws. Interest may be charged on the overdraft. This form shows the date of the overdraft, the amount of the overdraft, and whether it was finally covered by a deposit.

Bank Officer's Annual Report.—Shortly after receipt of the depositor's annual financial statement, the credit department posts it upon the comparative statement form, which appears later in the credit file. The bank officer who deals with the customer then prepares a brief summary of the financial condition of the business and of the relationship of the customer with the bank for the period covered by the financial statement. This summary points out the principal items on the latest financial statement, makes comparisons with the preceding statement, and calls attention to any favorable or unfavorable changes during the year. Though not found in all bank credit files, this form has a definite advantage in requiring an officer's report at least once a year on every borrowing account. This annual review gives a worth-while perspective on the customer's financial position and his relationship with the bank during the preceding year.

Account Analysis Form—By means of cost analysis, a bank determines whether an account is being carried at a profit or a loss The practice of analyzing accounts has become general, with the increasing recognition that banks should receive a reasonable return for the services they render Some banking institutions analyze all of their accounts monthly Other banks analyze their accounts once or twice a year, by selecting a certain number for analysis each month until the entire list of depositors has been covered When an account regularly shows a loss, a monthly analysis should be conducted for a reasonable period to provide accurate knowledge before discussion with the depositor

Cost analysis reveals operating losses not only in small accounts, but also in large accounts which are so active that the amount earned fails to cover the expense incurred in handling them This activity includes the frequency of checks written, the number of deposits, and the amount of wrapped currency furnished On accounts showing a loss, the bank will generally make a regular service charge or require larger balances in order to earn a reasonable return

The specific analysis included in the credit file shows an average daily balance for the year of $103,500, from which is deducted $19 320, the average amount uncollected or in transit daily From the net balance of $84 180 the bank deducted 21 per cent as the amount required for its reserves This percentage was above the minimum required by law on demand deposits in this central reserve city bank On this reserve the bank earns no return. The balance, or $66 502 20 in this illustration, represents the average net loanable funds for the month analyzed

The bank estimated that its average income on all loanable funds was 2½ per cent, so it earned $138 54 on this account for the month under review

Following the computation of income is the analysis of the costs of handling the account The customer wrote 512 checks, which at $ 05 per check cost the bank $25 60 Twenty-four deposits at $ 12 per deposit cost $2 88 The deposits included 560 checks drawn on other banks in the home city and collected at an estimated cost of $ 026 each, or $14 56 325 out of town checks collected at an estimated cost of $ 026 each, or $8.45, and $10 520 in currency, which cost $ 60 per $1000 to handle, or $6 31 The bank also included a general overhead charge of $1.00 monthly, made on all accounts irrespective of activity The cost of the 512 printed checks which the bank furnished during the month was estimated at $5 50 The total cost of all these items amounted to $64 30 Hence the bank earned a profit of $74 24 for the month When low interest rates prevail and with

the increased cost of doing business, many small banks have found an increasing proportion of their income derived from service charges.

Statement Comparison

The second section in the credit folder consists of a comparative statement sheet. Each balance sheet that is received is condensed and spread upon this columnar form. The information on both the front and the reverse sides of this form facilitates comparison and analysis of trends from one year to another. The comparative form illustrated may be used for most types of business concern. Some banks use slightly different forms for utility, finance, and small loan companies, partnerships and individuals, the principal difference being in the classification or caption of the various accounts. Many banks use the same comparative statement sheet for proprietorships, partnerships, and corporations, making necessary changes with pen and ink.

Memoranda and Interviews

The third section consists of memoranda and interviews. Page one in this section of the credit file is a special "Memo Sheet" and is the last page in this section. Upon opening a new account, the bank officer receives this sheet from the credit department. The printed matter at the top of the sheet requests him to report all of the pertinent information he obtained from the depositor when he accepted the account. The sheet is then placed in the credit file. Any space remaining on this page is used for future memoranda. The second and subsequent pages in this section are used by the loan officer to summarize any information of value obtained in conversation with the depositor and others.

Direct Correspondence

The fourth section in the credit folder is used to file correspondence that the bank has had with its customer. Some banks file the correspondence itself in the credit folder. Other banks abstract or copy the correspondence entirely, as illustrated in the credit file. In the latter case the saving in space and filing costs and the ease of reading consecutive correspondence may compensate for the expense of copying or abstracting. The practice adopted will depend largely upon the volume of credit work and the manner in which various responsibilities are shared by the executive head and the members of the department.

Other Correspondence

The fifth section of the credit folder contains correspondence that the bank has had with others relative to the customer. At times this correspondence may be voluminous, and at other times limited. Some banks file the original correspondence, whereas others make abstracts. This correspondence may, for example, be with guarantors regarding a loan made to an affiliated business enterprise.

In this section are filed copies of agreements of all kinds, such as subordination agreements under which, for example, liabilities due to the officers by a company may be subordinated to the bank's loans. There may be agreements to pay dividends only after retiring all or a part of the bank debt, to hold the salaries of the management below certain figures until bank loans have been liquidated, to maintain a minimum current ratio, to maintain a prescribed minimum working capital, and to use all surplus earnings to retire an old bank debt which has become a slow loan provided a new loan is advanced to rehabilitate the company.

Investigations

The sixth section consists of investigations. The nature of investigations made by the credit department is explained in Chapter III and is also indicated in the typical credit file. Investigations of borrowing accounts are invariably made at least once every year with other depositories and with important trade creditors. This is one of the most important activities of the bank credit department and will be referred to from time to time throughout this volume.

Clippings and Circulars

The seventh section is made up of newspaper and magazine clippings and circulars pertaining to the customer. Some banks make abstracts of the clippings, and others file them directly. In this section of the file are also kept applications for listing securities on a stock exchange, underwriting circulars and newspaper advertisements of stock and bond offerings. Only clippings that have a real bearing upon the customer's credit standing should be filed. A news report of a large damage suit or of a suit involving patents would, for example, ordinarily be included whereas a regular newspaper advertisement of the customer's products would usually not be.

Financial Statements and Mercantile Agency Reports

The eighth section of the credit folder is made up of financial statements and mercantile agency reports. In the event that statements are parts of detailed audits, they may be placed in separate manila folders. In that case the principal credit folder may be marked with a small red sticker to indicate that there is a separate statement folder.

The statement form illustrated in the sample file was prepared by the bank for use by corporations in submitting financal information. The essential difference between this form and that used by partnerships and individuals is the elimination of items relating to the outstanding capital stock. Various financial statement forms in current use are shown in Chapter VI. When a business or an individual presents an audit satisfactory to the bank, the statement form is unnecessary.

Mercantile agency reports are kept up to date and filed with the financial statements for ready reference by the loan officer. In the case of non-borrowing accounts, financial statements are often obtained from mercantile agencies rather than from the depositor.

Contacts

The ninth and last section consists of two parts: a contact record sheet and a sheet to record all inquiries on the name.

Interviews with Officials.—The purpose of the contact record sheet is to provide in easily available form a record of calls made by the banker upon the customer at his place of business. Sometimes the record of these calls is placed in the front of the folder on the memorandum sheets. In that case this particular form may be eliminated or used simply to note the date of the call, the initials of the officer who called, and the name of the individual who was interviewed. The other details would be placed on the memorandum sheet, and the single sheet of the contact form would then show at a glance the record of calls made by officers of the bank over several years, and whether the program of calling had or had not been neglected. Well-managed banks find it worth their while to call upon their customers in order to become better acquainted, actually to see the plant, farm, or store in connection with which loans have been made, and to look for evidence of good or bad management as indicated by the external condition of the fixed property or inventory.

The banker has a better understanding of the customer and his problems after seeing him at work at his place of business. The customer also has

an opportunity to become better acquainted with the banker and to learn what assistance he may fairly request and receive As a result there is a freer and franker discussion of the banking relationship, to mutual advantage

Replies to Inquiries—This form is sometimes not included in the credit folder, but is kept by the department as one of the auxiliary credit records On it is listed the names and addresses of all individuals and businesses that inquire about the customer, together with the dates inquiries are received and answered An additional column is provided for the initials of the person answering each inquiry This column is important when inquiries are answered verbally, as in large cities When inquiries are received and answered by mail, this column is less essential, since carbon copies of all letters are kept in a separate file for ready reference

A complete record of inquiries is helpful in the periodic investigation of a customer The probabilities are that those who inquired have had, or have contemplated having, credit relations with the customer and so will be able to give the benefit of their experience with him Bank inquiries may also mean that the inquiring banks have depositors transacting business with the customer If organizations of questionable integrity and reputation should make inquiries, the bank might find it expedient to investigate them The businesses and individuals with whom a customer has relations may thus reveal valuable information to the credit department.

Additional Sections

If the credit folder is on a large corporation with one or more affiliated companies that have accounts with the bank, information regarding these names is at times included in the credit file The names of individuals associated with the company who have accounts with the bank might also be included If, for example, the president of a concern has an account at the bank, the credit information on his name might follow the section of the credit file dealing with the corporation account In this way information on affiliated individuals or concerns is readily available in one place for reference when a particular situation is being analyzed

Supplementary Files

In the case of a large corporation, a bank may keep two or three large credit folders on it In this case the folders may be simply marked "Frederick Jones & Co, Inc, File No 1," "File No 2," and 'File No 3"

In addition, as already explained, there may be a separate file containing bulky detailed audits or financial statements.

SUPPLEMENTARY RECORDS

Average Balance and Loan Card

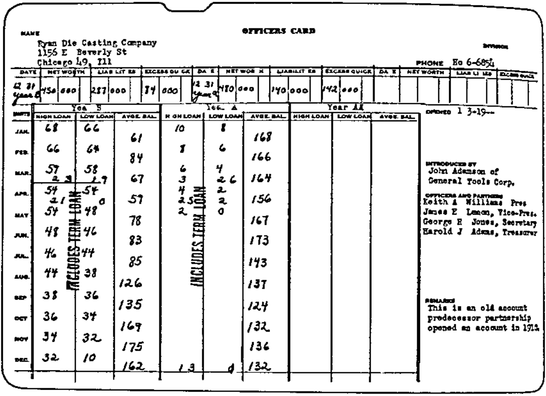
The most important of the records supplementary to the credit file, and in some banks the only supplementary record, is the average balance and loan card. Sometimes this card is placed in the credit folder, but in most banks it is filed in a cabinet and outside of the folder. Two or more sets of balance and loan cards may be kept in different places in the bank: one set in the credit department, for example, and another set more readily available to the loaning officers.

The information that is given on the typical average balance and loan card is indicated in Figure 7, on pages 38, 39, showing both the front and the reverse of the card. The two sides of the card furnish a vast amount of vital information, including the name and the address of the account, the date the account was opened, the individual who introduced it to the bank, and the names of the officers or partners in the case of corporations and partnerships. Space may be provided for additional information, such as the dates on which checks were returned "N.S.F." (not sufficient funds); the monthly service charge, if any is made; the net worth, liabilities, and excess quick assets for several consecutive years; associated accounts, other bank connections, guarantors on loans, and remarks. The card also contains space for a continuous record of the average balances and loans for six years, so that the loaning officer may quickly see the relationship of the customer to the bank for a reasonable period of time.

In the illustration the average balance for January, year A, was $168,000, and for February, $166,000. The card shows the high and low points for loans each month. In January the customer owed a high of $10,000 and a low of $8,000. In April the high loan was $4,000 and the low one, $2,000. The loan was paid in May, and the customer remained out of debt for the remainder of the year.

Notice that the loan space is divided into upper and lower sections. The upper section is for the record of direct loans to the customer, while the lower one is for indirect loans. When the concern borrows on its own note, the obligation is a direct loan. If the borrower brings a customer's note to the bank and the bank discounts the note (with the customer's endorsement), the loan is an indirect one. To illustrate, in the month of

Figure 7A Average Balance and Loan Card (*front*)



OFFICERS CARD

NAME
Ryan Die Casting Company
1156 E Beverly St
Chicago 49, Ill

DIVISION

PHONE Ho 6-6854

DATE	NET WORTH	LIABILITIES	EXCESS QUICK	DATE	NET WORTH	LIABILITIES	EXCESS QUICK	DATE	NET WORTH	LIABILITIES	EXCESS QUICK
12 31 Year 8	450 000	287 000	74 000	12 31 Year 9	410 000	140 000	142 000				

OPENED 1 3-19--

MONTHS	Year S HIGH LOAN	Year S LOW LOAN	Year S AVGE. BAL.	Year A HIGH LOAN	Year A LOW LOAN	Year A AVGE. BAL.	Year AA HIGH LOAN	Year AA LOW LOAN	Year AA AVGE. BAL.
JAN.	68	66	61	10	8	168			
FEB.	66	64	84	8	6	166			
MAR.	57 2 3	58 1 7	67	6 3	4 2 6	164			
APR.	54 2 1	54 0	57	4 2 5	2 2	156			
MAY	54	48	78	2	0	167			
JUN.	48	46	83			173			
JUL.	46	44	85			143			
AUG.	44	38	126			137			
SEP.	38	36	135			124			
OCT.	36	34	169			132			
NOV.	34	32	175			136			
DEC.	32	10	162	1 3	0	132			

INCLUDES TERM LOAN

INCLUDES TERM LOAN

INTRODUCED BY
John Adamson of
General Tools Corp.

OFFICERS AND PARTNERS
Keith A Williams Pres
James E Lemon, Vice-Pres.
George H Jones, Secretary
Harold J Adams, Treasurer

REMARKS
This is an old account
predecessor partnership
opened an account in 1914

March, year A, the upper section shows a high of $6,000 in direct loans and the lower section a high of $3,000 in indirect loans In the same month the card shows that the low point for the direct loans was $4,000 and for indirect loans was $2,600

The card illustrated is a rather complete one Some cards do not provide space for all the information that this one makes possible All cards do, however, provide a record of loans extended and balances carried from month to month over the years

Records to Facilitate the Work of the Credit Department

The more extensive credit departments necessarily use a number of other forms of lesser importance than those described Four in particular are helpful in carrying on a systematic and organized routine

1 One member of the department may have the responsibility of obtaining mercantile agency records on all accounts When the bank is large, the number of accounts is often so great that a record must be kept of

Figure 7B Average Balance and Loan Card (*reverse*)

OFFICERS CARD

NAME
Ryan Die Casting Company
1156 E. Beverly St.
Chicago 49, Ill.

DIVISION

PHONE EO 6-6854

DATE	NET WORTH	LIABILITIES	EXCESS QUICK	DATE	NET WORTH	LIABILITIES	EXCESS QUICK	DATE	NET WORTH	LIABILITIES	EXCESS QUICK
12-31 year E	230 000	178 000	45 000	12-31 year D	288 000	295 000	71 000	12-31 year C	388 000	432 000	-33 000

DATE	Year E			Year D			Year C		
	HIGH LOAN	LOW LOAN	AVGE. BAL.	HIGH LOAN	LOW LOAN	AVGE. BAL.	HIGH LOAN	LOW LOAN	AVGE. BAL.
JAN	33	32	42	21	20	67	58	56	62
FEB	32	31	44	20	19	82	56	54	89
MAR	31	30	42	19	18	73	53	51	79
APR	30	29	45	18	17	76	14 51	0 49	48
MAY	29	28	59	17	16	105	49	47	63
JUN	28	27	54	16	14	96	47	44	63
JUL	27	26	59	14	13	101	44	42	83
AUG	26	25	74	66	66	122	42	40	63
SEP	25	24	66	66	64	114	86	84	95
OCT	24	23	83	64	62	128	83	81	134
NOV	23	22	89	62	60	149	25 81	0 79	150
DEC	22	21	75	60	58	113	79	68	114

INCLUDES TERM LOAN

INCLUDES TERM LOAN

ASSOCIATED ACCOUNTS
Warren Mfg. Co.

GUARANTORS
FOR GUARANTIES & SUBORDINATION AGREEMENTS SEE FILE

CHECKS RETURNED "N.S.F."

SERVICE CHARGE BASIS
EXEMPT FROM SERVICE CHARGE. BALANCE ADEQUATE TO CARRY ACTIVITY IN THE ACCOUNT

Fig. 11

the dates on which the agency reports are requested and subsequently received.

2. Another member of the department may keep a complete record of all investigations and their final disposition. These investigations may be conducted to revise the credit files of the bank or for correspondent banks, depositors, or officers of the bank.

3. Records are often kept showing the financial statements normally due each month, as well as the requests for financial statements which have not been answered.

4. The credit department may also keep records of the new loans made each day and of the loans maturing each day for a week or so ahead. The credit files on these names are kept up to date so that full information will be available in case renewals are requested.

part two

SOURCES OF CREDIT INFORMATION

chapter III

SOURCES OF CREDIT INFORMATION

A SMALL BANK IN A RURAL COMMUNITY WILL ORDINARILY HAVE correspondent banks in several larger cities. In contrast, a large city bank in New York or Chicago may have several hundred and occasionally several thousand correspondent banks located throughout the United States and in scores of foreign countries. Each of these hundreds and thousands of banks compiles and interchanges credit information with many others.

In addition, every business enterprise is a potential source of credit information regarding the individuals and the businesses with which it has relationships. The gathering, compiling, recording, and interpreting of credit information is thus a dominant influence in American business life. The thoroughness, intelligence, and accuracy with which credit investigations and analyses are made today have assumed the proportions of a practical science. The result has been a steadily increasing number of well-organized, fully equipped, and competently managed bank credit departments.

To keep pace with business changes, the bank credit department has a twofold responsibility: first, to keep a careful record of the businesses that go out of existence annually and of the new businesses that are established within some practical geographical limitations, for the benefit of the new business department; and, second, to revise the records of existing businesses, particularly borrowing accounts.

More work is naturally required in the credit departments of newly established commercial banks and trust companies and in those that have only in recent years fully appreciated the advantages of complete and

accurate credit information These institutions must not only revise present records but also increase the number of names on which comprehensive information is maintained

Bankers are occasionally credited with uncanny accuracy of judgment in detecting poor credit risks without using extensive credit information Even with this unusual gift, if it does exist, bankers find it profitable to base their credit decisions upon exact facts Insufficient investigations and inadequate facts are thin soil from which to expect sound loan policies to spring and grow Equipped with full credit information gathered from all available sources, however, the banker will avoid hasty loan decisions and bring to his task an intelligent comprehension of the borrower's request, a sympathetic understanding of the debtor's business and its operation, and a willingness to give every reasonable consideration to the borrower's credit requirements Only an inadequate appreciation of the significant role of the credit department in the successful operation and management of a well-operated commercial bank could account for the failure to develop these credit facilities adequately

Bankers obtain credit information (1) direct from the executives of the business concerned or from the individuals who are under investigation, while indirect information comes from those in a position to be familiar with the various factors that make up the credit responsibility of the business enterprise or the individual

INFORMATION FROM BORROWERS

Direct information may be obtained through the following four complementary approaches

1 Personal interviews These take place generally in conferences at the bank or at the borrower's place of business

2 Investigations by the bank These may take a variety of forms, depending upon what information is sought The banker may call upon the borrower at his place of business, make a careful investigation of the plant, the equipment, the farm, or other assets, and personally examine the accounting records In large banks a staff of accountants may specialize in making detailed independent audits of the financial condition of borrowers

3 Correspondence with the borrower The correspondence may relate to such matters as general and specific business conditions, explanations of items in the balance sheet and the income statement, price trends, inven-

tory problems, competition, expansion policies, estimates of credit requirements, and the program for retiring obligations. If the borrower is located near by, this information may be obtained in personal interviews. When the borrower is located at some distance, however, correspondence generally is necessary.

4. Financial and operating statements: Financial statements may be prepared by the borrower's own bookkeeper or staff of accountants, by independent accounting firms, or by the bank's own accountants.

Personal Interviews

A superior type of information may frequently be obtained by contact with the subject. In discussing his inventory and labor problems, sales and managerial problems, and future plans, the borrower gives the banker an unusual opportunity to "size up" the credit risk. A brief but accurate record of every interview should be summarized and recorded in the credit file. In this way there is gradually built up in the file an excellent case history. This record enables the banker to determine whether the management has demonstrated its ability to discharge its responsibilities over a period of years.

A personal conference also permits the banker to discuss with the borrower the various aspects of his financial statement, particularly increases or decreases in important items between the last two statement dates, and items that may not be fully understood by the banker. The statements may, for example, show a large amount due from officers. The banker should ascertain the origin, trend, and liquidity of such an item. Certain officers may be living beyond their means and borrowing from the business for that purpose. He should also learn what possibility there is, if any, that such loans will be repaid in the near or distant future.

Investigations by the Bank

An idea of what a bank can accomplish in investigating a credit risk directly for itself, for a correspondent bank, or for one of its commercial customers may be obtained by examining actual reports of investigations made by the trained employees of an efficient credit department. Two such reports are presented below in the approximate form in which they would appear in the credit file. In the typical credit file there would be a wide margin on the left-hand side of the page, and in that margin would

appear the initials of the investigator and the date on which each call or interview was made[1] Sometimes an entire investigation is started and completed on a single day by one member of the credit department At other times several members of the department may work several days on an investigation As in the typical credit file, most of the following information is written in the first person, in the words used by the individual being interviewed

A Typical Bank Investigation of an Individual—The first illustration of a typical investigation made by the credit department of a bank deals with an individual who was establishing a new business enterprise The Safe Trust and Savings Bank, Anko, Iowa, wrote the Traders National Bank of Chicago, Illinois, on February 28 requesting information regarding the general reputation and financial responsibility of one Raymond U Metcalf, 7642 West Kilman Avenue, Chicago, Illinois, as one of their customers expected to enter into business dealings with him The name did not appear in either the current telephone directory or the city directory The following investigation was then conducted

Credit Agency Number 1 "We have no information on this individual"

Credit Agency Number 2 "We have had no occasion to compile a report on this name"

Credit Agency Number 3 "We have no information on this individual"

Telephone Information Operator "This individual does not appear to be one of our subscribers"

The Elton Light Company "This person is not a user of our electric service We have no information regarding him"

The Northern Gas Company "This individual, as far as our records indicate, is not a user of our service We are unable to be of any assistance"

Investigator's Report

Upon referring to the numerical street and avenue guide, which was several years old, I [i e, the credit investigator] learned that, at the time the book was compiled, the property at this address was vacant However, according to the guide, the property at 7642 was occupied by Samuel Easton, and his name appeared in the telephone directory I called Mr Easton on the telephone, and he stated that one Martin Roberts resided at 7642 West Kilman Avenue Mr Easton was not acquainted with Mr Metcalf I telephoned the home of Mr Roberts, and he said that Mr Metcalf had been boarding with his family for the past month He further stated that Mr Metcalf was contemplating going into business by himself, and he promised to have him get in touch with me

Mr Metcalf came in to see me today [one day later] He indicated that he

[1] For the exact appearance of these pages, see the typical credit file between Chapters I and II

intended to engage in business for himself and would operate strictly on a commission basis, selling bottled and canned fruits, vegetables, pickles, and condiments in behalf of several out-of-town fruit and vegetable packers. He stated that he was 35 years of age, and had been born and raised in Ohio. This would be his first business venture on his own account, as he had formerly been employed by the Smith Food Products Co., Inc., as sales manager for twelve years, and for about five years previously had been employed as a salesman for the Best Corporation, both companies being located at Cleveland, Ohio. He claimed that he would seek no credit, but would operate strictly on a commission basis, merely obtaining orders; shipments would be made direct to his customers by the companies he represented. In addition to representing the two companies by which he had formerly been employed, he believed that in the very near future he would be able to make additional connections.

When questioned as to the extent of his resources, he stated that he owned no real estate, stocks or bonds, but believed that he had sufficient capital to enable him to live comfortably until his business was fully established. At the present time he maintained no bank account, but would form a connection with one of the smaller neighborhood banks within a month or two. He formerly carried a small savings account with the National Bank of Cleveland, Cleveland, Ohio, the account number being 136942.

His business would be operated from the above address temporarily. If the venture should be successful, an office would be opened in the central manufacturing district. Mr. Metcalf indicated that he had severed his connection with the Smith Food Products Co., Inc., as he had felt that there was little prospect for him to go higher in an organization which was more or less a family concern. He was still a young man, and he believed that, with the experience and with the contacts he had acquired, he should be able to make a success of this business. Mr. Metcalf was single. He made a very good appearance and impressed me favorably.

I telephoned the Chicago offices of each of the two corporations by which he had formerly been employed. The managers of each of these offices confirmed the information submitted by Mr. Metcalf. They also explained that he had left their services voluntarily. They believed him to be a gentleman of good character and reputation, and that, with the experience acquired through his connections with them, he should be successful in his operations.

I also communicated with his former bank connection, and they replied that he carried a small three-figure savings account, but, as the relationship involved no extension of credit, they had had no occasion to inquire into his affairs. In our behalf they made several inquiries in Cleveland, and the information developed there was of a uniformly complimentary nature. Mr. Metcalf's record is apparently clear of suits and judgments. He has the reputation of meeting his obligations promptly.

The report on Mr. Metcalf is relatively simple, but it is typical of the investigations that are made of individuals who are comparatively unknown and who have decided to start in business on their own account.

The first reports, which indicated that there was no such individual, might have led a less experienced investigator to draw hasty and erroneous conclusions.

If the investigator had ceased to research for information after having failed to obtain any leads from the first six sources, his report not only would have been of no value, but might have reflected unfavorably upon Mr. Metcalf. When the credit investigator had completed his inquiries, he was able to make an intelligent report which was helpful to both the inquiring customer of the Iowa bank and Mr. Metcalf himself.

A Typical Bank Investigation of an Established Enterprise.—The second illustration is representative of investigations which are made of successfully operated business enterprises and which indicate no particularly unusual hazards. The Federal National Bank of New York City wrote the Manufacturers Trust Company, Akron, Ohio, on March 14 requesting credit information concerning the Arlan Distributing Company, 502½ North Central Avenue, Akron, Ohio. One of the bank's depositors had been selling to that concern in substantial amounts and was contemplating a material increase in its line of credit. The following investigation was then made by the credit department of the Manufacturers Trust Company, Akron, Ohio.

Credit Agency Number 1 "We have an up-to-date credit report on this company. It contains comparative financial statements for the past three years, including the last fiscal balance sheet as of December 31, 19__. We have made no recent trade investigation. Trade revisions made in the past, however, have always found the company well regarded and with a uniform record for retiring its obligations in accordance with terms of sale. We shall send you a copy of the report, and as soon as the new trade investigation is completed, the full details will be sent to you. The concern maintains an account at the Safe Trust and Savings Bank."

Mr King, Credit Department, Safe Trust and Savings Bank: "We have been favored with a very satisfactory account from this concern since the inception of the business in 1930. Prior to that time the principal was a partner in another business which had maintained an account with us for a good many years. The account averages in satisfactory five-figure proportions, balances last year having been better than $15,000. In recent months balances have been slightly under that amount. We have loaned the concern in liberal amounts on an unsecured basis, supported by the endorsement of the president of the company whose outside worth is very nominal. Last year our loans reached a peak of $50,000. The account owes us $10,000 at this time. Borrowings were liquidated in full, three or four months last year. The principals have demonstrated their ability to operate the business profitably, even under adverse business conditions. Our last trade investigation was made a year ago and was very satisfactory. We believe that the concern is fully responsible for credit

for its regular trade requirements. We have been furnished with their complete audit as of last December 31, which, according to our analysis, showed a tangible net worth of $161,600, consisting of capital stock $120,000 and surplus $41,600. Current assets amounted to $216,400, including cash of $14,000, accounts receivable of $132,800, and inventory of $69,600 to pay current liabilities of $61,400, of which $50,000 was due to us. Comparative financial statements reveal consistent increases in tangible net worth and net working capital. Operations last year were conducted at a profit after income taxes of approximately $25,000 on a sales volume of $956,000. The concern was started with a modest capital, and earnings for the most part have been retained in the business. In the event you should care to consult several of their suppliers, they are doing business with the following concerns [six trade references were submitted]."

Trade Reference Number 1: "We have been doing business with this concern for several years and have not hesitated to grant credit up to $20,000 on sixty-day terms. Bills have invariably been discounted in ten days. We consider the account one of the best on our books. The principals are capable and are highly regarded in trade circles."

Trade Reference Number 2: "We have been selling this account for the past two years, the highest credit extended being about $15,000, and invoices have been paid promptly on sixty-day terms. At the present time $6,000 is owing, none of which is due. The account has been a very desirable one."

Trade Reference Number 3: "This enterprise is well known in the trade and has no trouble in securing credit for its reasonable requirements. Our account has never run over $5,000, although we would gladly go higher. All invoices have been retired on discount terms."

Trade Reference Number 4: "This is a splendid account, as bills are always discounted. The principals in our opinion are aggressive and know their line. They never miss a discount with us."

Trade Reference Number 5: "We have a very high regard for the management of this business and do not hesitate to sell them up to $10,000. Invoices are discounted."

Trade Reference Number 6: "This is a very small account with us, never running over $1,000, and bills invariably have been discounted."

Most bank investigations are similar to these two cases. They reveal the nature of the business, financial condition, and banking record of the borrower. Using the facts he has obtained, together with such information as he may already have, the banker then makes his decision. The borrower's record and financial condition may not warrant the extension of credit, but dishonesty ordinarily is not a factor to be considered.

These reports show that the credit man would have failed to discharge his responsibilities properly if he had not made thorough and complete investigations. In the first illustration the inability of an Iowa business concern to evaluate a credit risk in Chicago might have resulted in a loss of profitable business. In the second illustration the failure to obtain full

information might have led the customer of a New York bank to deliberate unnecessarily about extending credit to a successful enterprise The moral is that every avenue of possible information must be followed up conscientiously and skillfully

Correspondence with the Borrower

As a worth while source of credit information, correspondence with the borrower ranks close to a personal interview In a small community where all accounts are local depositors, there is little need for correspondence As soon, however, as a bank begins to accept accounts from depositors located at a distance, correspondence becomes an important means of obtaining information In a large city the conditions are different, and correspondence is often carried on with local depositors who are some distance away The correspondence may cover explanations of various items on the balance sheet, income statement, or supplementary figures, reasons for changes in important items since the date of the last balance sheet, current progress of the business, problems confronting the management, and information regarding credit lines with other banking institutions

There are three principal conditions under which a bank ordinarily will correspond directly with a borrower (1) to ascertain the amount of total confirmed lines of credit, (2) to obtain an explanation of one or several items in the balance sheet, and (3) to obtain interim financial or operating information

For purposes of illustration, typical letters requesting information on each of these three points are presented

Total Confirmed Lines of Credit—In the case of a depositor who borrows at several banks, a loan officer needs exact data regarding his total confirmed lines of credit. Each bank with which the customer does business quite naturally might request the same information The following three paragraphs are extracts from a letter written by the president of a successful corporation to the vice president of a depository who was seeking information of this nature

In order that your records may be complete, we are pleased to inform you that we have credit lines of $250 000 confirmed by each of the following three banks on our plain unsecured note

Reliable National Bank	— Minneapolis
Old National Bank	— Chicago
Safe National Bank	— New York

These lines, totaling \$750,000, are the same as we had last year and, we believe, will be ample for our needs for the coming year.

If we find that additional loans are required, we shall be pleased to take the matter up with you again, as you have suggested.

Explanation of Balance Sheet Items.—When the meaning of a particular item in the balance sheet or in the supplementary figures of a borrower is not clear, the banker often writes for that information. At times a written explanation is desirable, particularly if it is complicated, so that there may be no misunderstanding. Information of this nature is, however, often obtained in direct interviews, then summarized and placed in the credit file. The following four paragraphs are extracts from a letter written by the treasurer of a wholesale grocery house in answer to a letter requesting an explanation of an item of "Commitments" carried at \$75,000 in the auditor's certificate attached to a recent balance sheet:

In response to your letter of June 25, relative to the item of "Commitments" appearing in the certificate attached to our balance sheet, for \$75,000, we are pleased to give you the following schedule representing the items which make up this amount:

Flour	\$ 5,000
Coffee	15,000
Sugar	10,000
Canned vegetables	35,000
Canned fruit	10,000

Under our contracts, we are permitted to take out merchandise as we wish it. As a matter of fact, a substantial portion of the canned goods contracts runs for ten months.

You are familiar with our business, and know that contracts are entered into prior to the packing season. We feel the contracts we now have are very advantageous, in view of present market conditions.

We trust this explanation is satisfactory. If there are any other questions, please write us.

Interim Information.—In addition to the customary yearly balance sheet and income statement, the banker may wish to obtain information from time to time during the year regarding the progress of a business, especially of one that is not in a particularly strong financial position. The following three paragraphs are extracts from a letter written by the president of a canning company to a banker who was anxious to ascertain the condition of the business after the first six months of its fiscal year:

We are pleased to enclose our balance sheet as of November 30 and our income figures for the six months.

You will note that our current position shows further improvement. Collec-

tions are good and sales are continuing ahead of a year ago The drought which prevailed in some sections of the Middle West reduced the corn pack considerably, so that we are experiencing a strong demand

We expect to be out of debt to our banks not later than March 15

Financial and Operating Statements

The significance of exact information in the form of balance sheets and income statements cannot be overstressed The detailed explanations and the interpretations of the various sources of vital credit information which come under this category are treated in Part III of this volume At this point we desire merely to emphasize the extreme importance of reliable, comprehensive figures Balance sheets, income statements, surplus accounts, budgets, and trial balances, all will be carefully described and interpreted in separate chapters

INFORMATION FROM OUTSIDE SOURCES

No less important than the information obtained directly from the borrower is that obtained indirectly from those who have had actual business relations with him or who have had occasion to investigate his antecedents Important facts regarding the establishment, the growth, and the business dealings of many concerns are also reported in newspapers, magazines, and public records The following are seven important outside sources of supplementary information

1 Bank checkings Investigations made with other banks, particularly with those that share an account

2 Trade checkings Investigations with concerns in the same trade as the borrower, or with any business enterprise with which he has had trade relations

3 Public records Records such as judgments entered, suits pending in the courts, real estate transfers, and mortgages are available in the various courts

4 Newspapers, periodicals, and directories Information is available in the daily press, financial journals, trade papers, trade association directories, government bulletins and pamphlets, and studies of Better Business Bureaus

5 Reports from attorneys Services of attorneys located in the same community as the borrower may be utilized

6 Investment manuals Investment manual publishing companies prepare a mass of information regarding the earnings and the financial

condition of corporations, particularly those with securities in the hands of the public.

7. Mercantile agencies: Mercantile agency reports are used by almost every bank credit department. Dun & Bradstreet, Inc., is the only general agency covering every line of business activity. A number of specialized agencies confine their activities to one or several closely allied lines of business activity.

Each of these sources is of assistance to the banker in evaluating a credit risk. The resourceful banker will determine the most suitable combination of these sources to use in a particular case.

Bank and Trade Checkings

The two most frequently used outside sources of credit information are other banks and mercantile concerns. If two or more banking institutions do business with the same customer, exchange of information and experiences is of mutual benefit. In such circumstances, progressive banks will ordinarily give the most complete information to each other. The information exchanged will include the history of the account since the bank has had it and a full résumé of its deposit and borrowing relationships.

Checking with other banks for the purpose of obtaining their full experience and then soliciting their accounts is regarded as unethical. Any banking institution following such a practice would soon find itself in a position where no other commercial bank or trust company would give complete credit information to it, for fear that the information would be used to the disadvantage of the bank that had the account. However, there is splendid co-operation and a commendable spirit of fair play among banks in all parts of the country in the exchange of credit information.

In the larger central reserve cities the bank credit departments maintain staffs of investigators to make direct personal or telephone calls upon other banks and also upon trade creditors. Many banks in smaller cities have no investigators and carry on most of their investigations by mail or by telephone. Form letters are often, possibly too often, used by banking institutions for this same purpose.

Public Records

A vast amount of credit information is available in Federal, state, and county courts and records. The typical bank credit department seldom

uses these comprehensive records. Often information originating at these sources is utilized only when it has found its way into the press.

The principal source of record information regarding business transactions is probably the office of the county clerk. The type of information available at this source is concerned with the ownership, pledge, and transfer of real and personal property, including deeds, mortgages, liens, and wills, assessed valuations for tax purposes, corporate charters, registration of trade styles and assumed names, suits, judgments, and all judicial proceedings, civil and criminal, within the jurisdiction of the state courts. Federal cases, criminal and civil, including bankruptcy proceedings, are recorded in the Federal district courts.

Financial information of a most extensive character must be filed with the Securities and Exchange Commission at Washington, D. C., and to somewhat less of an extent at New York and Chicago, at periodic intervals by every corporation (except railroads, common and contract carriers by motor vehicles, and commercial banking institutions) whose securities are traded on a national stock exchange, and by substantially every corporation (except railroads, common and contract carriers by motor vehicles, and commercial banking institutions) that sells an issue of securities to the public with an aggregate offering price of $300,000 or more. A duplicate copy of all information filed with the Securities and Exchange Commission by a corporation whose securities are listed on a national stock exchange is also filed for public inspection at the office of the particular exchange on which the security is traded.

Reports filed with the Securities and Exchange Commission contain detailed individual and consolidated balance sheets, income statements, and reconciliation of surplus, breakdowns and changes during the year in relevant balance sheet items, such as marketable securities and other security investments, amounts due from directors, officers, and principal holders of the equity security, investments in securities of affiliates, and indebtedness of affiliates, property, plant, and equipment, reserves for depreciation, depletion, and amortization of property, plant, and equipment, intangible assets, and details of any outstanding funded debts.[2] The commission also makes running statistical studies of numerous types, including the tabula-

[2] The most recent issue of Regulation S-X, *Form and Content of Financial Statements*, published by the Securities and Exchange Commission, April 1, 1947, contains seventy-eight pages of detailed instructions and forms for registrant commercial and industrial corporations, management investment companies, unit investment trusts, insurance companies other than life and title insurance companies, committees issuing certificates of deposit, bank holding companies and banks, and natural persons.

tion of combined balance sheets and combined profit and loss statements by individual lines of industry and commerce.

Under the provisions of Section 15 of the Securities Exchange Act of 1934, as amended, all brokers and dealers (except those whose business is exclusively intrastate) engaged in the purchase and sale of unlisted (over-the-counter) securities are required to file a registration statement with the Securities and Exchange Commission. Detailed information covering the date of formation and the type of business entity—such as proprietorship, partnership, or corporation—together with the full names and a description of the activities for the preceding ten years of each partner, officer, and director, must be furnished on these forms. Information regarding the location of each branch office, number of and classification of employees by occupation, and the names of states in which the broker or dealer is licensed, or has been barred from transacting business, also must be given.

Under the provisions of Section 17 of the Securities Exchange Act of 1934, each broker and dealer in securities, registered pursuant to Section 15 of the act, has been required, since January 1, 1943, to file an annual statement of financial condition. Statements of financial condition must be filed within forty-five days of the statement closing date, and financial statements for any two consecutive years may not be filed within less than four months of each other. Except for a limited number of brokers and dealers who are specialists in certain types of securities listed on the several stock exchanges or who deal exclusively in United States Government or municipal bonds, every broker or dealer in the United States has filed a registration statement and one or more balance sheets with the Securities and Exchange Commission. This information is a matter of public record. Registration statements and statements of financial condition must be filed with the regional office of the Securities and Exchange Commission for the region in which the broker or dealer has his principal place of business.

Equally comprehensive financial information and data must be filed at least annually with the Interstate Commerce Commission, Washington, D.C., by all public carriers, pipelines (other than those for water and gas), and freight forwarders engaged in interstate or foreign commerce. Class I motor carriers,[3] for example, must file an exhaustive annual report on specially prepared forms totaling seventy-one pages. This most compre-

[3] A Class I motor carrier is defined by the Interstate Commerce Commission as any interstate passenger or freight motor carrier whose average gross operating revenue from interstate and intrastate operations combined is $100,000 or more annually.

hensive schedule covers full details of organization and control, such as names of partners and, in the case of corporations, the names of officers and directors with the amount of their individual interests in the business, type of service rendered—whether carriers of general freight, household goods, or any one of fifteen other distinct classifications, detailed balance sheet with full explanation of every relevant item, an unusually complete profit and loss statement, breakdown of operating property, schedule of equipment obligations showing changes during the year, and list of routes in operation This extensive information is open for public inspection

Information similar to that filed with the Interstate Commerce Commission on the classifications under its jurisdiction must also be filed with the Federal Communications Commission, Washington, D C., by all radio and television broadcasting stations Business enterprises in this line operate under a public license, which stipulates the frequencies to be used, the power of transmitters, and the hours of broadcast Detailed reports concerning ownership, financial condition, and extensive technical data must be filed (*a*) when an application is made for the original C.P (construction permit), (*b*) when an application is made for the renewal of license each three years, (*c*) when an application is made for transfer of control (assignment of license), and (*d*) when an application is made for a construction permit for changes in station equipment (on existing stations a construction permit must be applied for whenever there are substantial changes in equipment, usually in connection with changes in frequency, power, or location, or modernization, usually this is required only on changes amounting to over $5,000) Financial information only must be filed with every application for a license Whenever an original or modifying construction permit is applied for, all information must be given When the work is completed, a new license must be applied for At this time the new financial statement showing the expenditures and condition of the business at the completion are submitted All of the information above is available for public inspection The operators of radio and television broadcasting stations are also required to file annual operating figures, but these are not available for public inspection

Similar extensive reports and financial information must also be filed with the Civil Aeronautics Administration by all civil airlines and with the Federal Power Commission by all producers and distributors of electric power and by all gas pipeline companies

The Federal and state governments also publish numerous reports on prices, sales, production, inventory position, and supplementary facts in

leading industries. For example, the following six bureaus of the Federal government are widely known and utilized by businessmen in obtaining reliable periodic figures and indexes for specific purposes:

The Bureau of the Census, in co-operation with state and local governments, has made available the census of population and of manufacturers since about 1800, census of distribution and service trades since 1929, continuous monthly figures on important trades and industries by co-operative arrangements with trade associations, and continuous monthly figures on vital statistics and expenditures.

The Bureau of Agricultural Economics makes available data on agricultural commodity prices, volume of shipments, and special subjects, such as farm values and mortgage financing.

The Bureau of Foreign and Domestic Commerce makes available monthly indexes on trade and industry, and special studies of operating costs in various lines of business activity.

The Bureau of Labor Statistics makes available monthly indexes of employment, payrolls, wholesale prices, and quarterly figures on the cost of living.

The Board of Governors of the Federal Reserve System makes available weekly and monthly figures of member banks and of the Federal Reserve Banks, bank debits to individual accounts, monthly figures on department store sales and collections, and scattered monthly figures on wholesale trades in certain Federal Reserve districts.

The Internal Revenue Service makes available annual data on statistics of income for corporations and individuals, balance sheets, and operating figures.

Numerous other departments, bureaus, agencies, and instrumentalities of the Federal government carry on statistical studies varying in quantity and importance.[4] In ten states—namely, Arizona, Colorado, Kansas, Massachusetts, Michigan, Nevada, New Hampshire, Vermont, Wisconsin, and Texas—financial information in the form of a balance sheet, and in certain cases some operating information, is filed by every business corporation operating in those states and is open for public inspection.

[4] Supplementing the original source material as issued three principal publications of the Federal government contain extensive statistical data. These are *Survey of Current Business*, a monthly publication, and *Business Statistics, A Supplement to the Survey of Current Business*, a biennial publication, both published by the Office of Business Economics of the Department of Commerce; and *Statistical Abstract of the United States*, a yearly publication of the Bureau of the Census of the Department of Commerce.

Newspapers Periodicals and Directories

In this category are included financial journals, trade papers, trade association directories and investigations of Better Business Bureaus The newspapers and trade magazines in particular, contain helpful information for the credit department Reports on such subjects as plant expansion, development of new inventions and models, production and sales in various industries commodity price trends, refinancing plans, changes in ownership and management, death notices, and even stories of questionable escapades involving some customer of a bank, are all news items of importance to the efficient bank credit department

For general economic and business information, a credit man will profit by reading one or several such periodicals as *The Wall Street Journal, New York Journal of Commerce, Commercial and Financial Chronicle, Federal Reserve Bulletin, Survey of Current Business of the United States Department of Commerce*, and *Dun's Review and Modern Industry*

Many classes of trade directory are helpful as supplementary sources of information Directories of attorneys doctors, officers and directors in business corporations and accountants may give brief reports regarding the personal history, educational background, and length of time an individual has been in his present location and in some cases, information regarding his financial standing *Who's Who in America* gives biographical information about men who have become publicly prominent Bank directories such as *Polk's Bankers Encyclopedia* and the *Rand McNally Bankers Directory*, give the complete lists of commercial banks and trust companies in the United States, with their principal officers, important banking correspondents, and selected items from their most recent financial statements The *Bankers Almanac and Year Book*, published annually by Thomas Skinner & Co, of London, England, gives a complete list of banks throughout the world These volumes also report the date of incorporation the names of officers, and the principal items in the balance sheets of banks As a rule directories are most useful in obtaining the names and locations of all individuals and businesses engaged in a certain occupation Directories are frequently published by trade associations

Better Business Bureaus

There are 110 local Better Business Bureaus in the principal cities of the United States and Canada[5] Each Better Business Bureau is a separate

[5] As of March 30 1959

and completely independent non-profit corporation, separately governed and separately financed. These bureaus maintain an organization known as the National Association of Better Business Bureaus, Inc., in Cleveland, Ohio—a non-operating organization which holds an annual conference to provide for the discussion of matters of mutual interest. In addition there is also the National Better Business Bureau, Inc., in New York City, similar in form to the local bureaus, but financed by co-operating concerns whose interests are national in scope. Its activities are similar to those of the local bureaus, but confined chiefly to the field of national advertising and selling.

The aims of Better Business Bureaus are eightfold:

1. To increase public confidence in advertising, salesmanship, and business generally by assisting in the elimination of unfair and deceptive advertising.
2. To promote accuracy in advertising, through the co-operation of advertisers themselves, advertising media, advertising agencies, and properly constituted authorities.
3. To aid in the elimination of unfair competition through promulgation of ethical standards.
4. To provide an unbiased medium for the settlement of disputes involving alleged false or misleading advertising between competitors, and between business concerns and their customers.
5. To expose fake promotions, and to aid in the prosecution of fake promoters.
6. To warn the public against the endless easy-money schemes which divert hard-earned dollars from the channels of legitimate investment and trade.
7. To encourage the public to "investigate before investing."
8. To furnish dependable, disinterested information on offerings of securities, business opportunities, or services—thus not only protecting the public, but also removing unjustified suspicion from legitimate enterprises.

To illustrate the work of Better Business Bureaus, the operations of the Chicago bureau will be described. The Chicago Better Business Bureau is a non-profit corporation established under the laws of Illinois for the purpose of carrying out the eight objectives just listed in and about the city of Chicago. The bureau attempts to curb false and deceptive advertising and business practices that tend to mislead the public or injure competing businesses. Extensive files and indexes are maintained on promotion schemes that have been shown to be without merit. The names and past activities of racketeers and business parasites are catalogued and made available upon request to legitimate inquirers.

Newspaper advertising, which offers merchandise to the public, is closely scrutinized. When the truth of a particular advertisement is questioned, a bureau shopper is sent to the store to make a purchase or the necessary examination. In the event the merchandise does not meet the expectation

of the reader of the advertisement, the store is visited for the purpose of fixing responsibility for the questionable advertisement and of preventing a similar "error" in the future

In this work the bureau employs, on a part-time basis a staff of about fifty housewives who, by virtue of their occupation, obtain a natural consumer reaction to the advertisements and to the merchandise The policies of the bureau are determined by its directors who are selected from, and are representative of, the entire bureau membership These men serve without pay and give their advice and their time willingly

The Chicago bureau handles complaints that involve a specific misrepresentation in advertising or by a salesperson For instance, if a pair of stockings is described as full fashioned and ringless when in fact they are neither, the bureau will handle the matter to the extent of requesting the retailer to deliver stockings of this description or refund the purchaser's money Proper allowance is made for honest mistakes by clerks The bureau therefore feels that the store should first be given the opportunity of adjusting a situation of this kind

The bureau does not assist a complainant in breaking a contract when no irregularity exists in the transaction For example, complainants often request that the bureau obtain a refund of a down payment of $10, $20, or $50 on furniture, merely because they later preferred furniture in another store Assuming that no fraud or misrepresentation existed in the negotiation, the bureau carefully avoids the false position of recommending the cancellation of bona fide contracts and the refunding of down payments

A store that consistently misrepresents facts in its advertising will obviously lose its credit standing The weekly bulletin of the Chicago bureau reports the names of businesses engaged in questionable practices and also describes these practices

Attorneys

In special cases a bank may obtain credit information from an attorney residing in the same community as the individual or concern under investigation Some banks make it a practice to use the attorney as a source of information only in towns of less than, let us say, twelve thousand, where he might be acquainted with most of the businessmen of the town, or be able to obtain information without too great difficulty On the other hand, occasional firms of attorneys in larger cities have found this source of

revenue sufficiently great to warrant opening up a commercial department to specialize in collecting and disseminating credit information.

Several volumes are published yearly, containing up-to-date lists of attorneys located in every city, town, and hamlet in the United States. The attorneys in one such volume—namely, *The Attorney's List of the United States,* published by the United States Fidelity and Guaranty Company, Baltimore, Maryland—will undertake to furnish credit reports on individuals or business concerns in their immediate vicinity. Charges for such reports vary according to the population of the town in which the attorney is located.

Investment Manuals

The facilities of an efficiently operated bank credit department may be rounded out by the use of one or more investment manuals on industrial, public utility, railroad, financial, and insurance corporations. The two well-known services are Moody's Investors Service, Inc., and Standard and Poor's Corporation. Alfred M. Best Co., Inc., a third concern, specializes in the compilation and interpretation of somewhat similar information on insurance companies of all kinds. These services are described and reviewed in Chapter V.

Mercantile Agencies

Of all sources of credit information available to the banker, the most extensive are the reports of the general and specialized mercantile credit agencies. Dun & Bradstreet, Inc., has reports on every business enterprise in the United States, and reports that are currently revised on every active commercial and industrial business enterprise in the United States and Canada, whether located in the fastness of the mountains or on the main street of a metropolis, and whether the capital investment is $1,000 or $100,000,000. Specialized mercantile agencies have credit reports on every concern in active business in their specialized lines. The extent of the activities and services of these organizations is described in the following chapters.

chapter IV

THE OPERATIONS OF DUN & BRADSTREET, INC.

THE ACTIVITIES OF DUN & BRADSTREET, INC., FALL INTO NINE DIVISIONS The object of each division is the investigation, preparation, analysis, and editing of information concerning some particular phase of commercial and industrial life, to assist in the more orderly flow of banking credit, merchandise, and services The functions of these nine divisions may be summarized as follows X62'1 K3

1 The Credit Report Department investigates, analyzes, and edits a continuous run of credit reports on every active commercial and industrial business enterprise in the United States and on thousands of other business concerns 50364

2 The Special Service Division provides tailor made reports based on exhaustive investigations by highly trained specialists on a cost-plus basis

3 The Reference Book Department publishes *The Reference Book* six times a year

4 The Credit Clearing Division gives a rapid special credit-advisory service over the telephone to manufacturers of ladies', men's, and children's garments selling to retail stores This division also publishes *The Apparel Trades Book*, a specialized reference book, four times a year

5 The Municipal Service Department prepares comprehensive specialized reports on states, counties, municipalities, and similar borrowing units for investors in the securities of these units

6 The International Division collects information on business enterprises throughout the world

7 The Mercantile Claims Division collects past-due accounts

8 The Marketing Services Company Division carries out surveys and

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research projects to fill a wide range of specific needs for commercial and industrial concerns.

9. The Magazine Department publishes a monthly magazine, *Dun's Review and Modern Industry*.

The distinct methods of operation and the services rendered the business community by each of these divisions are explained in this chapter. Each division has a specific economic function, and each fills a definite niche in the American scheme of competition and capitalism. Of the entire nine divisions, however, the Credit Report Department embraces the primary collecting, analyzing, and reporting functions for which R. G. Dun & Co. was established by Lewis Tappan in 1841, and the Bradstreet Co. by John M. Bradstreet in 1848. These two enterprises were merged in March 1933 to create the existing organization of Dun & Bradstreet, Inc. In the many years of their individual existence up to the date of their merger, they had gradually developed collateral services. These additional services were continued by the consolidated organization, but the collection and analysis of credit data on active business concerns and the transformation of this information into credit reports have remained the outstanding functions.

The Credit Report Department of Dun & Bradstreet, Inc., investigates, analyzes, and then prepares credit reports on every active commercial and industrial business enterprise that operates in the United States. There is, therefore, a current report which can be immediately delivered or mailed in answer to any request for credit information from any banking institution, insurance company, manufacturing establishment, wholesaling house, or other subscriber to the service.

This immense field of activity is covered by no other one organization. A large staff must be trained and efficiently managed to cover the 2,600,000 business enterprises located in every country town and hamlet, every seaside fishing village, every mining center, and every summer resort from Aroostook County in Maine to the Hawaiian Islands. The enormity of this task is intensified by differences in size of capital investments and by the great turnover in active business enterprises. Approximately 18 per cent of all active concerns go out of existence each year, and approximately the same number start in again. This turnover—this possibility of easily fading out of and then re-entering the business picture and also, with a little money and initiative, of setting up an independent business—is one of the outstanding expressions of our free capitalistic system.

A study made in 1959 of business births and deaths in the United States indicated that every day an average of 1,167 commercial and industrial

business enterprises opened their doors for the first time Of this number, approximately 48 per cent *succeeded previously existing enterprises,* through the incorporation of partnerships or the reorganization of sole proprietorships into partnerships The remaining 58 per cent were entirely new ventures During 1959 an average of 1,076 enterprises passed out of the picture each day

The schedule in Figure 8 of the ebb and flow of commercial and industrial business concerns in the United States gives a concrete picture of this high turnover

Figure 8 Ebb and Flow of Active Commercial and Industrial Businesses (*based on listings in the Dun & Bradstreet* Reference Book)

Year	Active Concerns*	Names Added	Per Cent	Names Deleted	Per Cent
1947	2 410 000	682 000	28 3	412 000	17 1
1948	2 555 000	681 000	26 7	527 000	20 7
1949	2 684 000	609 000	22 7	476 000	17 8
1950	2 692 000	532 000	19 8	524 000	19 5
1951	2 614 000	446 000	17 1	525 000	20 1
1952	2 643 000	400 000	15 2	371 000	14 1
1953	2 673 000	412 000	15 4	382 000	14 3
1954	2 639 000	406 000	15 4	440 000	16 7
1955	2 640 000	420 000	15 9	420 000	15 9
1956	2 636 000	445 000	16 9	446 000	16 9
1957	2 659 000	430 000	16 2	407 000	15 3
1958	2 682 000	411 000	15 3	387 000	14 4
1959	2 715 000	426 000	15 7	393 000	14 5
1960	2 704 000	420 000	15 7	442 000	16 3
1961	2 632 000	378 000	14 3	450 000	17 1
1947 61	2 637 000	473 000	17 9	440 000	16 7

* Active concerns are the total number of industrial and commercial names in the July issues of the Dun & Bradstreet *Reference Book* These listings include all types of business enterprise that are seekers of commercial credit in the accepted sense of the term—namely, manufacturers wholesalers retailers building contractors, and certain types of commercial service, such as motor carriers and airlines In general the term excludes financial institutions, railroads, investment trusts, insurance companies, real estate holding corporations terminals farmers those giving professional services, such as lawyers and doctors and many small one man services

The figures in the table above present a picture of the continual daily change which takes place within our highly competitive capitalistic economic system. A large part of these business births are small-scale enterprises with net invested funds well below $30,000. Large corporations seldom disappear, though their control shifts continually as their securities are bought and sold, as operating managements come and go, and as mergers, consolidations, and reorganizations take place. In 1886 the courts decided that a corporation [1] was a person in the meaning of the "due process" clause of the Constitution. This decision gave unprecedented security to the larger corporation, which at that time was becoming a power in our social as well as our economic life.[2]

The yearly number of business deaths is an indication that high hopes are not sufficient qualifications for survival in this highly competitive struggle for business existence. A moderate proportion are cases where men wished to retire, so that the termination of ownership involved no particular stress or strain. Some discontinuances represented successions where an individual proprietorship was taken over by a partnership or by a corporation. In the bulk of the cases from year to year, however, capital became exhausted, sales dropped off, and there appeared to be no solution except withdrawal from the daily business struggle.

CREDIT REPORT DEPARTMENT

To investigate, analyze, and prepare credit reports on approximately 2,600,000 active commercial and industrial concerns, Dun & Bradstreet, Inc., has divided the country into eight regions, each of which has a

[1] For a scholarly and interesting treatment of the types of colonial business organization used by pre-Revolutionary land companies and the immediate post-Revolutionary land companies prior to the chartered corporation, see Shaw Livermore, *Early American Land Companies* (New York: The Commonwealth Fund, 1939). This volume contains "a theory of the origin of the modern business corporation and an analysis of the influence of unchartered bodies such as the land companies in shaping it."

[2] The story of our Constitution and the problems involved in its interpretation are presented in a most enlightening manner in Burton J. Hendrick, *Bulwark of the Republic* (Boston: Little, Brown & Co., 1937). Up to 1870 the story revolves not around problems of economics, banking, business, or credits but largely around the one subject of slavery. In this early period, "constitutional" crises were mainly civic and political. Since 1870, however, the cases receiving the greater part of the attention of the Supreme Court have developed more and more out of the new industrial and economic order. These cases cover problems of transportation, communication, public utilities, *manufacturing on a large scale, and those supplementary* problems that, Hendrick writes, were "created by the growth of a new social conscience, the realization that property is unfairly divided, that the masses do not sufficiently participate in the prosperity they do much to create. . . ." This change in viewpoint is brought home by the many problems, almost all of which have been of an economic nature, that have been considered by the Supreme Court since 1933.

regional manager in charge of all activities within it These regions approximate the geographical limits of the Federal Reserve Districts, except that Federal Reserve Districts Seven and Nine, Districts Eight and Ten, and Districts Three, Five, and Six are combined into three large regions, respectively

The eight regions into which the United States is separated are, in turn, divided into forty-two districts Each district represents a smaller geographical unit ranging from an entire state, such as Colorado or Utah, where the population is quite widely scattered, down to a few counties in thickly populated sections, such as New York City, Philadelphia, and Chicago These districts have "sub offices" and "reporting stations," so that, all in all, the organization consists of 140 offices of various sizes in the United States In Canada operations are carried on by a wholly owned subsidiary, Dun & Bradstreet of Canada, Limited, which has eighteen offices These offices are further supported by an extensive staff of thirty thousand correspondents and local representatives who live in almost every important city and town in the United States This extensive organization represents a steady development over the years since Lewis Tappan sent out his initial circular in 1841 inviting lawyers and others at distant points to become his experimental correspondents

Each of the 158 offices in the United States and the Dominion of Canada have staffs that investigate, gather pertinent credit information, analyze the data, and prepare the final credit reports Let us consider, for example, the reporting department in New York City This department utilizes the services of two hundred trained reporters Though the largest in the organization, it is typical of all offices

Receipt of Inquiry Tickets

Inquiry tickets requesting credit reports come into the New York office from two sources (1) subscribers who obtain service direct from the New York City office, and (2) other offices which relay inquiries from their local subscribers regarding concerns in New York City or its immediate vicinity on which these distant offices do not keep reports in stock.[3] The majority of regular or routine inquiries between offices move over a private wire network, which connects eighty-two offices from coast to coast with

[3] Most subscribers obtain service from the nearest office All subscribers, however, have the privilege of mailing inquiries direct to a particular reporting office A subscriber in Birmingham, Ala., for example, might mail all inquiries to the Birmingham office or to the San Francisco office on a San Francisco concern, to the St Louis office on a St Louis concern, and so on, receiving reports direct from these points

twenty-one way lines. These inquiry tickets are checked against the active files. A report, if current, is immediately mailed or delivered by messenger to the subscriber or to the relaying office, which in turn mails or delivers it to its local subscriber.

When the credit report is based on an investigation over six months old or does not contain the latest financial statement, or when the subject of the inquiry is a new concern not yet reported upon, the name is turned over to (1) one of the two hundred New York City reporters for immediate investigation, (2) mailed to a resident reporter if in a near-by city, or (3) mailed to a local correspondent. Outside the cities in which offices of Dun & Bradstreet, Inc., are located, business concerns are automatically investigated at some time during the year by (4) a traveling reporter. There are therefore four distinct classes of credit reporter constantly gathering credit information.

City Reporters

In most offices credit investigations on concerns located within the city limits are handled by three to ten trained reporters. The city generally is divided geographically, and all inquiries on concerns located in one district go to the same reporter, who becomes acquainted with the unusual sources of credit information and the managements of the business units within the limits of that district.

In New York City, however, where there are more active industrial and commercial enterprises than in any state except California, Illinois, Pennsylvania, and Texas, the work is broken down even more. First, inquiries on large enterprises are turned over to analytical reporters, who are highly trained specialists in investigating and analyzing only the larger business enterprises. Analytical reporters in the New York City office handle inquiries according to lines of industry rather than geographical districts. One reporter covers larger concerns that manufacture paints, varnishes, and heavy chemicals; another, larger concerns producing or selling iron and steel products; another, department stores and other large retailers; still another, larger enterprises in the leather industry; and so on.

Secondly, inquiries about concerns in a line of industry on which specialized divisions have been set up—such as manufacturing furriers, manufacturers of millinery, stock brokerage houses, and investment bankers—are turned over to a reporter in that particular division.

Thirdly, inquiries not covered by the preceding two divisions are turned over to reporters assigned definite geographical areas. These include all

lines of manufacturing, wholesaling, retailing, and contracting Standard narrative reports are prepared on these concerns

The city reporter's first call verifies the existence of a new concern When a report on an established business is being revised, he checks the street address, the names of the proprietor, partners, or officers and directors, and operating policies There are an infinite number of points to be covered in conversation with a representative of the business

In the course of this call, the reporter invariably requests an up-to date balance sheet and income statement If a concern has a complete set of books and draws off a financial statement at periodic intervals, a copy of that statement is accepted Statements audited by reputable outside accountants are naturally preferred When not audited, statements generally are signed by an authorized member of the management staff

Approximately 82 per cent of the commercial and industrial concerns in existence have a tangible net worth of $35,000 or less Many of the smaller concerns do not keep a complete set of books In such cases the reporter takes down the figures, as estimated by the person he is interviewing, on what is known as a "Form RS Statement Blank" The figures provide an approximate balance sheet, which the person interviewed is then asked to sign Other parts of the 'Form RS Statement Blank" are lined to receive the data that the reporter obtains in his conversation and in his own examination of the premises

Besides gathering all essential information on a business concern, city reporters also analyze that information and prepare credit reports There are about twelve hundred city reporters in the entire system in the United States

Resident Reporters

In addition to the city reporting staff, each office also has what is known as a resident reporting staff In New York City the resident reporting staff consists of thirty men who live and work daily in such near by cities as Yonkers, New Rochelle, Poughkeepsie, and Middletown, which all come under the jurisdiction of the New York City office These reporters devote their full time to gathering essential credit information on concerns in their immediate city Resident reporters, however, do not prepare credit reports

Inquiries on concerns in their territory are mailed to them daily These concerns are investigated by resident reporters in the same manner as city reporters The resident reporter, however, handles all lines of business,

large and small—newstands, delicatessens, drugstores, and lumber dealers—in his territory. The information is then mailed daily to the New York City office. Here "report writers" analyze the information from this source and from bank and trade investigations made simultaneously, and prepare the final credit report.

Resident reporters provide speed in gathering information and in bringing credit reports up to date. They are on the ground, become widely acquainted locally, and know the unusual sources of local information. There are 220 resident reporters from the Atlantic to the Pacific.

Local Correspondents

The Albany, New York, office has approximately 280 local correspondents, who are employed on a fee basis. There is at least one such correspondent in every community of a reasonable size. He may be a banker, an insurance broker, an established merchant, perhaps a wide-awake farmer, or otherwise employed, but willing to give a reasonable portion of his time to outside work of this nature.[4]

These correspondents are called upon for local investigations under two sets of circumstances. At certain peak seasons of the year, when more inquiries flow through for investigation than can normally be handled by the resident reporter, the excess is sent to the local correspondent for immediate investigation. In this way speed and promptness are assured. In smaller towns and villages, where no full-time resident reporter is employed, all inquiries calling for immediate investigation are forwarded direct to the local correspondent.

One or more correspondents are used in practically every city, town, and village in the country outside of those cities where offices are located. By 1846, when The Mercantile Agency was five years old, there had been built up a chain of 679 correspondents—352 to the New York office, 115 to Boston, and 212 to Philadelphia.[5] Today there are many thousands of local correspondents of this character throughout the country.

[4] Many well-known individuals have been local correspondents since R. G. Dun & Co. began. Two of the earliest were Abraham Lincoln, while an attorney at Springfield, Ill., and Ulysses S. Grant, while working in his father's retail hardware and leather store at Galena, Ill. John Calvin Coolidge, the father of Calvin, acted as a representative at Plymouth, Vt., for a period of fifty-two years, terminating with his death. He also ran a general store and a large farm; was telephone, telegraph, laundry, and news agent; looked after insurance policies; and served the interests in that section of the state of a bank of which he was a trustee. For the names of other well-known correspondents see Roy A. Foulke, *The Sinews of American Commerce* (New York: Dun & Bradstreet, Inc., 1941), pp. 350–53.

[5] E. N. Vose, *Seventy-Five Years of The Mercantile Agency* (New York: R. G. Dun & Co., 1916), pp. 25–6.

Traveling Reporters

In addition to the counties that comprise New York City proper, the New York City office has supervision over all investigations in the nine New York State counties nearest to the city, and over all concerns located in Bergen County, New Jersey. Each of these concerns is called upon each year automatically, regardless of the fact that many of them are also investigated in the course of the year by resident reporters.

For this field work, the New York City office employs ten traveling reporters. Each is furnished with an automobile and a schedule of cities, towns, villages, and hamlets which he must cover during the succeeding eleven and a half months. As he goes on this circuit, he calls upon and investigates locally every business enterprise at each location. This procedure is known as "automatic revision."

The traveling reporter, unlike the city reporter, the resident reporter, and the correspondent, does not handle inquiry tickets, that is, he does not revise a report when it becomes out of date. His job is to revise every name in every town on his route. At the end of each week he mails the results of his investigation and all financial statements obtained to his home office.

The 3,092 counties in the forty-eight continental states are covered in this same way by reporters traveling out from the various offices. From Edmonton in Canada, the traveling reporter eventually reaches the trading posts in the Arctic Circle, a thousand miles away, and in the same manner traveling reporters from St. Paul, Minnesota, get into every country town in Divide County, North Dakota, about seven hundred miles away. By this process every business enterprise in the country is directly called upon and investigated locally at least once every year.

Qualifications of a Credit Reporter

Just as a connoisseur realizes the perfection or the imperfection of a work of art after a careful examination, so the experienced credit reporter is able to pick up and put together facts that to the layman are of little or no importance. That an individual opens a restaurant while his entire previous business life had been spent in the cloak and suit trade, that an individual opens a gift store with a capital of $5,000 when a minimum of $10,000 is needed at a particular location, that an individual purchases an expensive automobile when an intimate knowledge of the financial condition of his business would indicate that he could support only a less

expensive one; that a wholesale business is being started on premises where rents are high; all such miscellaneous details must be recognized as valuable, studied, and analyzed.

The real credit reporter is part business specialist, part accountant, part detective, part student of logic, and part student of human nature. The man who takes the responsibility of assuming what any individual or group of individuals will do in a given set of business circumstances must have a keen insight into human nature. The value of the credit reporter depends upon his knowledge of local businessmen and conditions and the thoroughness of his investigation and reports.

Trade Investigations

While city reporters are calling upon local businesses and banking institutions, and resident reporters, correspondents, and traveling reporters

Figure 9 Inquiry Ticket Used by a Subscriber When Ordering a Credit Report from Dun & Bradstreet, Inc.

Dun & Bradstreet, Inc. INQUIRY TICKET

PLEASE PRINT OR TYPE

NAME
Henry Grocery Company, Inc.

TRADE STYLE BUSINESS

STREET ADDRESS
1814 No. Jones Street

TOWN & STATE DATE
Chicago, Ill. June 1, 19--

REMARKS FROM SUBSCRIBER:
FIRST ORDER ☐ SLOW PAY ☐ CHANGE IN OWNERSHIP ☐

Use reverse side for additional credit facts and references and check here ☐

9W2 2 (5 51)

R. O. | C. O | HQ OFF

REPORTING OFFICE
OR ☐
TO ☐
FL ☐
ANS ☐

RATED NQ ☐
BR OF

HOME OFFICE

CENTRAL OFFICE
OR
CD
AD

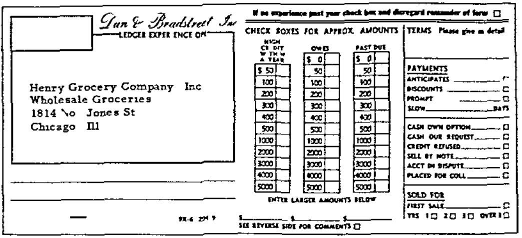
SEND____FILE COPIES OR ☐

are making their investigations, each home office is sending out thousands of inquiry blanks to merchandise creditors in all parts of the country to ascertain the manner in which each of these concerns is paying its current merchandise bills, the highest credit recently extended, terms of sales, and general relationship with trade creditors.

A Pittsburgh department store might purchase ladies' dresses in New

York City, men's suits in Chicago and Baltimore, canned foods in California, furniture in Virginia, and jewelry in Providence, Rhode Island To ascertain the paying record of this concern, trade slips are relayed by the Pittsburgh office to the Dun & Bradstreet offices in these cities, which then mail or deliver them to the particular local sources of supply, promptly pick them up, and finally return them to the originating office During 1961 over 20 200 000 of these trade slips, or about 80 000 each business day, were mailed or delivered to creditors to ascertain from them the detailed paying experiences of their customers

Figure 10 Inquiry Blank Used by Dun & Bradstreet Inc, in Obtaining Ledger Experience


Dun & Bradstreet Inc

LEDGER EXPERIENCE ON

Henry Grocery Company Inc
Wholesale Groceries
1814 No Jones St
Chicago Ill

9X-6 2M 9

If no experience just your check box and disregard remainder of form ☐

CHECK BOXES FOR APPROX AMOUNTS

HIGH CREDIT WITHIN A YEAR	OWES	PAST DUE
	$ 0	$ 0
$ 50	50	50
100	100	100
200	200	200
300	300	300
400	400	400
500	500	500
1000	1000	1000
2000	2000	2000
3000	3000	3000
4000	4000	4000
5000	5000	5000

ENTER LARGER AMOUNTS BELOW

$ ________ $ ________ $ ________

SEE REVERSE SIDE FOR COMMENTS ☐

TERMS Please give in detail

PAYMENTS
ANTICIPATES ________ ☐
DISCOUNTS ________ ☐
PROMPT ________ ☐
SLOW ________ DAYS

CASH OWN OPTION ________ ☐
CASH OUR REQUEST ________ ☐
CREDIT REFUSED ________ ☐
SELL BY NOTE ________ ☐
ACCT IN DISPUTE ________ ☐
PLACED FOR COLL ________ ☐

SOLD FOR
FIRST SALE ________ ☐
YRS 1☐ 2☐ 3☐ OVER 3☐

Supplementary Credit Information

There are three other routine practices in the collection of pertinent credit information

1 In January of each year a financial statement blank (similar to the form in Figures 11A and 11B on pages 73–74) is mailed to every active commercial and industrial business enterprise in the United States As these financial statements are returned, they are incorporated into reports and promptly distributed to all interested members who had filed inquiries on the respective concerns within the previous twelve months

2 A representative is maintained in most county centers to keep the agency promptly informed of all deeds, suits, mortgages, and similar instruments as soon as they are filed by or on business concerns

3 Newspapers and financial and trade periodicals are examined and

Figure 11A Financial Statement Form Used by Dun & Bradstreet, Inc. (*page 1*)

STATEMENT MADE TO

STATEMENT FORM C

Credit - MAN'S CONFIDENCE IN MAN . . . .

Dun & Bradstreet, Inc.

For the use of Subscribers as a Basis for Credit and Insurance

NOTE: Transmittal of financial statements on this particular form is optional. Financial statements on your own stationery or on that of your accountant will be equally useful. The full report of your accountant is preferred.

Business Name Used for Buying ______ Street Address ______

Other Name or Style Used, if any ______ City ______ Zone ______ State ______

Business ______ County ______

FINANCIAL CONDITION AS OF ______ 19 ___

IS THIS FISCAL ☐ OR INTERIM? ☐

ASSETS		LIABILITIES	
CASH	$	DUE BANKS	$
GOVERNMENT SECURITIES		Unsecured	$
MARKETABLE SECURITIES		Secured	
NOTES RECEIVABLE (Customers)		ACCOUNTS PAYABLE	
ACCOUNTS RECEIVABLE (Customers)		Not Due	$
Not Due	$	Past Due	
Past Due		NOTES PAYABLE-TRADE ACCEPTANCES	
Less Reserves		Merchandise	$
INVENTORY		Machinery & Equip't	
Finished Goods	$	Other	
In Process		DUE RELATED CONCERNS	
Raw Materials		Loans & Advances	$
		Merchandise	
OTHER CURRENT ASSETS		LOANS & ADVANCES	
	$	From Officers	$
		Others	
TOTAL CURRENT ASSETS		TAXES	
FIXED ASSETS		Federal Income	$
Land	$	Other	
Buildings		ACCRUALS	
Machinery and Equip't		Salaries & Wages	$
Furniture and Fixtures		Other	
Less Depreciation		MORTGAGES—DUE WITHIN 1 YEAR	
INVESTMENTS—RELATED CONCERNS		Real Estate	$
Stocks & Bonds	$		
Loans & Advances			
Accounts Receivable		TOTAL CURRENT LIABILITIES	
INVESTMENTS—OTHER		DEFERRED DEBTS—DUE AFTER 1 YEAR	
	$	Due Banks	$
		Real Estate Mtg	
MISCELLANEOUS RECEIVABLES			
Officers & Employees	$		
Other			
PREPAID—DEFERRED		PREFERRED STOCK	
DEPOSITS		COMMON STOCK	
SUPPLIES		CAPITAL—PAID IN SURPLUS	
		EARNED SURPLUS—RETAINED EARNINGS	
		NET WORTH (Proprietor or Partners)	
TOTAL ASSETS	$	TOTAL LIABILITIES AND CAPITAL	$

SUMMARY STATEMENT OF INCOME

NET SALES $ ______ FROM ______ TO ______

FINAL NET INCOME (LOSS) $ ______

DIVIDENDS OR WITHDRAWALS $ ______

BASIS OF INVENTORY VALUATION ______

RECEIVABLES PLEDGED OR DISCOUNTED YES ☐ NO ☐

CONTINGENT LIABILITIES $ ______ (SEE OVER)

ABOVE FIGURES PREPARED BY ______ Name Independent Accountant Yes ☐ No ☐

BUSINESS NAME ______

SIGNED BY ______

TITLE ______ DATE ______

SG 10 (32195)

(Use the reverse side of this form for submitting important supplementary details)

Figure 11B Financial Statement Form Used by Dun & Bradstreet, Inc (*page 2*)

STATEMENT OF INCOME

From ______ 19__ To ______ 19__

NET SALES			$	
COST OF GOODS SOLD				
GROSS PROFIT (LOSS) ON SALES				
EXPENSES				
Selling	$			
General				
Administrative				
NET INCOME (LOSS) ON SALES				
OTHER INCOME				
	$			
OTHER EXPENSES				
	$			
NET INCOME (LOSS) BEFORE TAXES				
Federal Income Tax	$			
Other Taxes on Income				
FINAL NET INCOME (LOSS)			$	

SURPLUS OR NET WORTH RECONCILIATION

SURPLUS OR NET WORTH AT START			$	
ADDITIONS				
Final Net Income	$			
DEDUCTIONS				
Final Net Loss	$			
Dividends				
Withdrawals				
SURPLUS OR NET WORTH AT END			$	

When financial statements prepared or certified to by independent accountants are transcribed to this form, indicate whether the statements transcribed are identical with the accountant's statement(s) Yes ☐ No ☐. If No, please describe adjustments. Attach copy of accountant's certificate.

THE FOREGOING STATEMENTS, IF CONSOLIDATED INCLUDE THE FIGURES OF WHAT OTHER CONCERNS? ______

ANNUAL RENT $ ______ LEASE EXPIRES ______ 19__ FIRE INSURANCE ON Merchandise $ ______ Machinery & Equipment $ ______ Furniture & Fixtures $ ______ Bldgs. $ ______ ARE OFFICERS AND EMPLOYEES BONDED ______

IS BUSINESS INTERRUPTION INSURANCE CARRIED? ______ IS BODILY INJURY AND/OR PROPERTY DAMAGE INSURANCE CARRIED? ______

BASIS OF VALUATION OF Fixed Assets ______ Marketable Securities—Investments ______

ARE LIABILITIES SECURED IN ANY MANNER? Yes ☐ No ☐ If Yes, describe the security and the manner of payment ______

STATE AMOUNT OF EACH CONTINGENT LIABILITY (Describe) ______

REAL ESTATE—LOCATION	Title—In Name Of	Value Mkt. ☐ Cost ☐	Mortgage	Due Date	Net Income—R. E.
		$	$		$

BRANCH LOCATIONS ______

NOTE. Comments will be appreciated on any phase of your operations, including developments since the statement date.

Full Names of all Officers, Directors, Partners or Proprietor If Partners, state if General Special or Limited

FULL NAMES AND TITLES	% of Ownership	Year of Birth	Marital Status	Life Insurance Carried for the Benefit of the Business
A.				
B.				
C.				
D.				
E.				

clipped daily, so that no new pertinent information affecting the credit risk of a concern favorably or unfavorably will be missed.

Special Notices

Information regarding suits, judgments, petitions in bankruptcy, composition settlements, voluntary or involuntary liquidations, the placing of chattel mortgages, and similar details of immediate value and interest to the credit departments of banking institutions and mercantile houses is distributed on Special Notice paper. This is merely pink report paper with the words "Special Notice" printed at the top of the page in red ink, so that the sheet will receive immediate attention by all who receive it.

Continuous Service

When a subscriber has made an inquiry about a particular concern, he receives the current report if it is up to date. If it is not, he receives the last available report, which then bears the stamp "Will Send Later." This indicates that the information is being revised. When the revision is completed, the report is immediately delivered or mailed to the subscriber.

This, however, is not the end of the service. A copy of every additional report edited during the ensuing twelve months, including regular revisions, automatic revisions, financial statements at the end of the fiscal year, trade investigations, and special notices, is subsequently delivered to the member. In other words, not only is every inquiry immediately answered, but the subscriber also receives every item of additional information distributed on that concern for an entire year. His file is thus automatically kept up to date.

When the year expires, a renewal notice is attached to the next report delivered to the subscriber on that name. The renewal notice states that service on this name has been completed, but that it will be continued for another year if the subscriber indicates he is still interested in the account by returning the renewal notice.

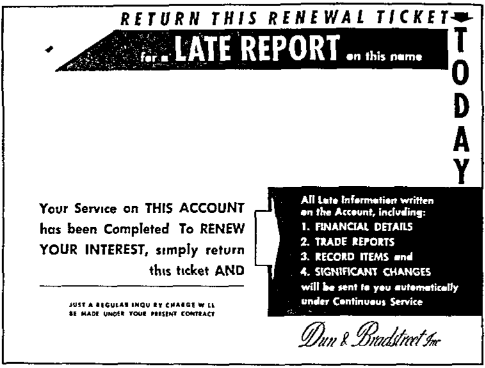
Various Types of Credit Report

What becomes of this vast array of information which is constantly being collected from so many divergent sources—including reporters' calls and investigations, bank and trade investigations, record items of judgments and suits, clippings from daily newspapers and magazines, offering circulars of securities, reports to the Securities and Exchange Commission,

and reports on file in certain states[3] This information is being constantly sifted, condensed, interpreted, and edited into credit reports

Two different types of "narrative" credit report are prepared by the Dun & Bradstreet organization the "Analytical Report" and the "Standard Narrative Report" The Analytical Report is prepared on large, complicated cases, which often have subsidiary and affiliated companies

Figure 12 Continuous Service Renewal Notice



requiring a study of consolidated and individual financial statements and of intercompany loans and merchandise sales The Standard Narrative Report is prepared on all other concerns Each report, consisting of one or more sheets of 8½-by-11 inch paper, contains concentrated credit information and the interpretation of it Although the information contained in these different types of report is quite similar, the arrangement and treatment vary

Analytical Report—A copy of an Analytical Report will be found in the typical bank file between Chapters I and II Analytical Reports run up to twelve pages in length A comprehensive treatment of data in the following order appears in an Analytical Report

1. Date of the Report: The date on which the report is edited.

2. Heading: The exact style of the business, whether it is a proprietorship, partnership, corporation, common law trust or estate, the line of business in which the concern operates, and the complete street and city address are first given. Subscribers are asked to "note whether name, business, and street address correspond" with the inquiry, as many concerns operate under styles that are very similar.

3. Officers and directors: The name of each officer, with his title, and the names of the men who comprise the board of directors, in alphabetical order.

4. Rating: The rating is a letter and numerical symbol (or the lack of one or both) which indicates in a broad way the approximate amount of capital invested in the enterprise and its existing credit soundness. The rating key with additional explanation will be found in Figure 15 on page 83. At this point the date the business started, the manner of trade payment, and the annual sales are also given.

5. Summary: In three or four lines of capital type, the summary gives the highlights, the strong or weak features of the risk. It represents a written concentrated interpretation of the rating.

6. History: At this point are mentioned the exact chronological, historical details of the business itself. This covers such points as the date and place of incorporation, if the business is incorporated; history of the business (if the concern is not newly organized) up to the time of its present incorporation; original authorized and paid-in capital stock, with increases and decreases since that time; classification of shares; names of other concerns absorbed or acquired (with dates), how acquired, and whether or not liabilities were assumed in each individual case. Following this information there appears data regarding the age, marital status, experience, past and present business connections of each officer; the amount of life insurance, if any, carried for the benefit of the concern; and the important connections of each director who is not an officer.

7. Operation-location: Under this heading, there is a brief outline of the method under which the business is operated, covering the products manufactured or sold, class of trade sold, territory covered, terms of sale, number of accounts, number of employees, location of plants and branch offices, trade names and brands used. This outline gives a picture of what the concern does and how it does it.

8. Subsidiaries: This section is one of the most important subdivisions of the Analytical Report. It covers corporate connections with underlying units, explains intercompany merchandise sales or loans, and describes

the individual financial condition of each subsidiary, if such data are available This information is essential in studying the financial responsibility of any unit in a group of concerns controlled by the same interest or closely allied ones Just as a father sometimes lends funds to a son, a brother, or a cousin, where possibilities for repayment in the near future are slim, so corporations at times make similar advances to related businesses

9 Comparative financial statements On this page balance sheets for the last three years are set up in parallel vertical columns in accordance with the principles outlined in Chapter VIII These comparative figures indicates the progress or decline of a business, by revealing the trends and fluctuations in net working capital, tangible net worth, liabilities, sales, profits, and other significant financial items

10 Analysis The analysis is a written interpretation of the comparative figures If the figures disclose a favorable trend and a healthy condition, that fact is brought out, and the reasons for it are given, if they reflect an unfavorable trend and an unbalanced condition, that fact is brought out, and the reasons for it are given The analyses of many businesses are complicated

11 Trade investigations Here are listed the detailed experiences of concerns extending current merchandise credit This section shows recent high credit, amount owing, amount past due if any, terms of sales, and manner of payment

12 Banking relations The current information obtained from the bank depositories indicates whether relations have been satisfactory, whether loans have recently been requested, and if so, whether the requests were refused or the loans granted, if the latter, then whether on a straight note basis, endorsed, guaranteed, or secured by collateral

Standard Narrative Report —This type of report is prepared on all concerns not covered by Analytical Reports Of the approximately 2,600,000 concerns listed in *The Reference Book*, the reports on the great majority are of this particular type There is, however, less credit interest in these names than in those covered by an Analytical Report Reports prepared on several hundred thousand holding companies, service lines of business, and miscellaneous enterprises which are neither listed in *The Reference Book* nor included among the 2,600,000 mentioned above, are also of this type As 82 per cent of all industrial and commercial enterprises in the country have a tangible net worth of $35,000 or less, many of these reports are somewhat limited in length The typical Narrative Report (Figure 13) is one to two pages long

Figure 13 Copy of a Standard Narrative Report

Dun & Bradstreet, Inc. Report — RATING CHANGE

5251 CD 26 FEBRUARY 2 196-
SIMPSON HARDWARE CO. HARDWARE & PAINTS
SIMPSON, WILLIAM J., OWNER

SPRINGFIELD OHIO
CLARK COUNTY
495 N. MAIN ST.

RATING: E 2½ to E 2

STARTED: 1948 PAYMENTS: Discount & Prompt
NET WORTH: $27,908 SALES: $89,446

SUMMARY

AN ESTABLISHED BUSINESS CONDUCTING A STEADY AND PROFITABLE VOLUME. FINANCIAL CONDITION IS WELL BALANCED.

HISTORY

Style was registered by Simpson July 17, 1948. Used for buying and advertising. Owner purchased this established business July 1, 1948 from Ralph T. Meyers. Capital was $18,000 of which $10,000 was a loan, since repaid.

William J. Simpson is 54, married, a native of Ohio. After graduating from Miami University in 1930, taught school until 1936. 1937-1945 was employed by the Wilson Wholesale Hardware Co., Columbus, Ohio, latterly in the accounting department. 1946-1948 was a salesman for Davis & Crocker, builders supplies, Springfield.

OPERATION-LOCATION

Retails shelf hardware and tools (65%), S. & W. Paints (20%) and housewares, cutlery, garden implements, glass, lawn mowers, seeds and sporting equipment (15%). About 90% of sales is for cash; 30 day credit is extended to contractors and householders. Two clerks, one part-time, are employed. Rents a store 25 x 60 in a residential shopping area on the outskirts of town.

FINANCIAL INFORMATION

A financial statement at December 31, 196--cents omitted:-

ASSETS		LIABILITIES	
Cash on Hand & in Bank	$ 4,604	Accts. Pay.	$ 3,064
Accts. Rec.	1,315	Accruals	621
Merchandise (Cost)	19,158		
Total Current	25,077	Total Current	3,685
Fixtures & Equip.	4,008		
Automobile	2,113		
Prepaid & Deferred	395	NET WORTH	27,908
Total Assets	31,593	Total	31,593

Net Sales January 1, 196- to December 31, 196-, $89,446; gross profit $19,551; Owner's salary and drawings $5,200. Net profit $1,886 after salary and drawings. Monthly rent $175; lease expires 196-. Fire insurance on fixtures $4,000; on merchandise $20,000.

Signed January 30, 196- SIMPSON HARDWARE CO. by W. J. Simpson, Owner.

-----0-----

When Simpson took over the business in 1948, sales were about $45,000 a year. By working long hours and advertising in the Suburban News he built up volume a little every year. Also there has been an increase in residential building on his side of town. Profits have increased as sales have expanded. Cash withdrawals from the business have been conservative. Merchandise turns satisfactorily and Simpson has been able to improve his financial condition a little each year. Carries good balances at his bank and has not borrowed since 1951.

PAYMENTS

HC	OWE	P DUE	TERMS	JAN 19 196-	
1551	356		2-10-30	Disc	Sold 1948 to date
900	600		2-10	Disc	Sold yrs
400			2-10-30	Disc	Sold 1950 to 11-1-6-
1600	300		Net 30	Ppt	Active acct.
733	112		Net	Ppt	Sold yrs

2-2-6- (301 49) (60)

PLEASE NOTE WHETHER NAME, BUSINESS AND STREET ADDRESS CORRESPOND WITH YOUR INQUIRY.

The foregoing report is furnished, at your request, under your Subscription Contract, in STRICT CONFIDENCE, by DUN & BRADSTREET, Inc. as your agents and employees, for your exclusive use as an aid in determining the advisability of granting credit or insurance, and for no other purpose. 9R2-4(32073)

SPECIAL SERVICE DIVISION

The Special Service Division was developed in 1943 to provide unusually exhaustive reports on a cost plus basis where the information needs of the subscriber go beyond the scope of the typical credit report. Each report is custom tailored to cover in detail those particular points about a subject in which the subscriber is especially interested Every source of information in the United States is thoroughly explored, and all information is exhaustively analyzed The following subjects suggest the wide scope of this division s activities

Management Interests

1 Over-all financial studies with a view toward purchase of a substantial or controlling interest in a business.

2 Intimate details of the background of the management of a business or its owners

3 Investigations of service organizations for reputation and standing in their respective fields, and qualifications to handle specific types of undertaking

4 Operating policies of potential or present distributors, and standing among customers and competitors

5 Facilities of contractors and suppliers to perform on contracts

Credit Interests

6 Particularly thorough over all investigations where unusually substantial credit is being considered by the subscribers

7 Details of unusual financing arrangements, existing or proposed.

8 Current comprehensive investigations for ledger experiences, information, and opinions including direct interviews with principal suppliers.

9 The competitive position held by a business concern in its industry

10 Trend, particularly changes affecting operations

REFERENCE BOOK DEPARTMENT

The Reference Book contains the names of all active commercial and industrial business enterprises in every city, village, town, and hamlet in the country Before the name is a number, and after the name are two symbols The number indicates the line of business of the concern It is the United States Standard Industrial Classification, a four-digit code representing the functions and lines of activity of all business enterprises, prepared by the Technical Committee on Industrial Classification, Divi

sion of Statistical Standards, Bureau of the Budget, Washington, D. C. The two symbols after the name indicate the estimated financial size of the business and its credit responsibility.

The Reference Book also contains valuable supplementary information for the banker and the mercantile credit departments, such as a list of banks and bankers with the principal officers and important correspondents, the population of every village, town, or city, and the designation of all county seats. Similar information is available on Canadian business enterprises, banks and bankers, maps, and population. *The Reference Book* is published six times yearly.

List of Active Business Enterprises

The most valuable feature of *The Reference Book* is the credit rating on each active commercial and industrial concern. With a *Reference Book* at hand, a credit man may at any moment look up the name of any active commercial or industrial business enterprise in the country, just as he would look up a name in a telephone directory, and obtain an approximate idea of its invested capital and credit responsibility. Even in the limited number of cases where insufficient data have been made available for this purpose, he may verify the fact that a particular concern is actually in existence, which is often an important fact in itself.

Figure 14 gives a typical section of a page in *The Reference Book*. Each page is divided into five columns, 14¾ inches long, listing the exact style of business concerns in alphabetical order under respective state, county, city, town, or village subdivisions. There is an average of 650 concerns on each page.

Trade Classifications

The four-digit Standard Industrial Classification Code at the left of each name refers to a trade classification, an index to which is found in the front of *The Reference Book*. By referring to this index, one may readily determine the specific line of business in which each concern is engaged. The code is valuable as a means of preparing lists for circulation purposes.

Rating Key

The two symbols at the right of most of the names comprise the capital and credit ratings. The capital letter represents "estimated pecuniary strength," and the numeral, "general credit" standing. Where sufficient

facts on which to base both a capital and a credit rating are not available, either one or both symbols may be omitted

Figure 14 Section of a Page from the Dun & Bradstreet, Inc , *Reference Book*

ING OFFICES— {2 Chicago 13 Detroit 42 Grand Rapids / 49 Toledo 81 Saginow 197 Green Bay}

72x62 Meaker W lliam E MortFrn 6 D 2½
C 07 23 Merritt Samuel J PltyHtchy 3
50 HA M chaels Harry F Nursery 1
54 51 Qua n Denn s D M lk 7 G 2½
59 13 Ressler H M & Sons Inc Drg 2
50x14 Se lenriek Bros TrSstnAtsup O 1½
55 11 Tob as Mary A (Mrs J F) Ats 1 E 2½

SIEBERT ▲ Kimball 42
Bk town Sage
C 15 11 Chap n Mary A & Robert GCntr D+ 2
54 13 Cortese John B GrMt 2 F 3
52 11 Good ch Lumber Co* D 2
42 12 Jackson & Moore Trkg Inv
A 75 38 Lawson Wi liam H Airp 9 3
57 12 Madden Samue F n 6 3
20 41 Oge tho pe M ll ng Co Flour D 2
17 41 Schwartz John Mason 6 Inv
57 22 Stanley Charles B Sr Frm 2
55 41 St mson Vaughn C Sstn 1 H 3½
53 93 Van Deusen C Emory Gs G 3½

SIMMONS 1,911 Ewing 13
Bk town Swenson
57 12 B auberger M tchell Frm 6 F 3½
50 21 Caffarell O l Co* Petrodt E 2½
52 21 Drummond W S HtgPlbgeqp E 3
54 12 Dugowsk Thaddeus Gr 1 G 3½
A 72 31 Endicott Lee E Pht 9 H 3½
*53 92 Excels or Dry Goods Co** E 2½
53 93 Fa rest Va ley Mercant le Co Inc Gs C 2
52 41 Hawley Everett NR Elcsup O 1½
54 12 H cks Raymond E & Georg anna 6 Gr J 3½
C 20 33 Mayo & Green Canning Co Inc B FruitVg D 2
59 13 Ra ner & Webe Drg F 3
24 21 Town ey Benjam n SPmll ★★
(See Owls Head)

SINGLETON 1,143 Smart 42
Bk town Ford R ver
54x12 Freeman Mrs Beat ce GrNot G 3½
54x92 Jaffe Albert E DelVg F 3
56 41 Strauss Ch drens Shop 7 G 3½
59 12 Todd Cut Rate Drg 8 H 4

SOLEDAD 5,675 Iroquois 49
EATON TR CO $882M
H D Wil ams Pr C E Morris Cas
(Also Branches)
LAUREL NAT BK $320M
J Roscoe E llott Pr I Lewis Cas
54 41 Ackerman Louis B Cnf 0 K 3½
52 11 A b ght Claude A Lbr 3
59 RA Al eyne Hubert B Mont F 3
17x21 Bayer Henry & Son PtgElcCntr K 3½
23 33 Bethofer Jos & Son Inc Drs B+ 1½
(B of Ka amazoo)
50 76 Belford J R Co* Plbgfix ★★
(See Fuller)
55 41 Bo th O l Co* Sstn E 2½
59x62 Bonaparte L B & Son Feed C 2½
Petrodt
55 41 B iskin A chie Jr Sstn 2 J 3½
57 12 B om eld Furn ture Co D 1½
54 12 Charles & Moon Gr 4 F 3
54 13 Coffin W lliam E GrMt G 3
75 38 Col ins Joseph O Atrp K 3½
51 16 Co umb a E ectronic Sa es 8 —

SOUTH DAWSON ▲ York 13
DAWSON TR CO $213M
J M Thompson Pr J L Marshall Cas
KNEELAND TR CO (Br of Kneeland)
17 31 Allen Electric Co Cntr 2
(Also Cedar Rapids Iowa)
32x81 Al man Stone & Tile Co D+ 2
50 62 Ame ican Electr c Supply Co 2 —
49 41 Andrade Wate Co* B+ 1½
56 12 Appleton Men s Apparel Shop Inc D 1½
34 63 Arnold Metal Products Co Met Stamping F 3
A 54 12 Babcock John L Jr Gr 9 K 4
59 HA Campbell s Gifts 8 E 3
59 13 Downs George Drg L 4
55x31 E sner T re & Linoleum Co 7 F 3
57 12 Gei er Robert R Frn E 2½
72 62 Gentry's Joseph Sons Inc Mort B 1
55 41 Jennings I H Sstn 6 K 3½
57 12 K & H Furn ture Co* C+ 1
54x12 Karl Benjamin M GrSstn G 3½
54 13 Kettle W lliam D GrMt G 3½
57 23 Lew s Irene Radios —
55 11 Old Gold Auto Co 3 E 2½
57 22 Paddock Frank N Hhldapl 1 —
42 13 Padgett Central Motor Lines Co C 2½
50 62 Sanchez E ectrical Products Corp C 2
50 28 Sanchez H E Paint Store W&R ★★
52 31 (2 See Lammove)
52 21 Stein Bernard J Lbr D 1½
14 41 Ste ton & Gas orowski Sand Gravel G 4

SOUTHVILLE (See Leesville)

SPELLACY (See Arden Wood)

SPERLING ▲ Randolph 81
1st NAT BK $729M
John Tracy Pr Paul W lliams Cas
54 23 Alden Norman O GrMt H 3½
C 55 41 Bell & Winfield Sstn 7 H 3½
56 64 Cabano Frank ChldSh J 3½
55 41 Ca lahan's Service Station C+ 1½
76 8A Canfield & Beauva s Mshp 0 G 2½
50 84 Cryder Tool & Spec alty Co G 3
54 23 D & M Seafood Co Inc 7 E 2½
17 91 Decker W ll am StructuralSteel F 3
C 53 31 Everard Walker C Vs 5 F 3
20 31 F & W P oducts Co Inc Canned Sfd 1
(Br of Chicago Ill)
27 22 Interstate Decorators PtgCntr E 2½
56 12 Iverson Clothing Co* MBcl D+ 2
58 22 Jablow Allen R Rst 8 G 3½
55 41 Kazim r Nathan S tn F 3
50 V1 Lomax J Reynolds Mont C 2
52 11 Lowe Max Lbr E 3
57x12 Mead Claude L FrnHhldapl 6 G 4
17x31 Metz & Harper ElcCntrMshp F 3
55x11 Natoli Inc AtsHhldapl D 2
55 11 Nea y Chevrolet Sales Co* D 1½
59 12 N chols A thur H Drg E 2½
54 13 Owens George H GrMt 7 F 3½
53 31 Picone Five & Ten Cent Store 2 F 3
A 58 13 P n Club Tav 9 H 3½
16 11 Pincus Bros Inc RoadCntr B+ 1
17 21 So tzer C arence D Pn hg 4 3
53 93 Stone Ken Gs 7 F 3
55x11 W ght John N AtsSstn Inv
24 21 W ght Wa lace M NR SPmll F 3
56 21 York Mrs Bird e H Wmwr E 2½

SQUIRES (See Sheppard Falls)

Figure 15, taken from the inside front cover of a *Reference Book*, gives a full picture of a Dun & Bradstreet rating key. There are sixteen classifications for "estimated pecuniary strength" These classifications range from "Aa," which represents corporations with invested capital in excess of $1,000,000, to "L," which represents a capital investment of less than $1,000 There are only four credit classifications high, good, fair, and

limited. Under these four classifications, however, there are sixty-four symbols indicating the general credit standing. This key represents a

Figure 15 Key to Ratings, Dun & Bradstreet, Inc.

KEY TO RATINGS

ESTIMATED FINANCIAL STRENGTH				COMPOSITE CREDIT APPRAISAL			
				High	*Good*	*Fair*	*Limited*
AA	Over	$1,000,000	- - - - - -	A1	1	1½	2
A+	Over	750,000	- - - - - -	A1	1	1½	2
A	$500,000 to	750,000	- - - - - -	A1	1	1½	2
B+	300,000 to	500,000	- - - - - -	1	1½	2	2½
B	200,000 to	300,000	- - - - - -	1	1½	2	2½
C+	125,000 to	200,000	- - - - - -	1	1½	2	2½
C	75,000 to	125,000	- - - - - -	1½	2	2½	3
D+	50,000 to	75,000	- - - - - -	1½	2	2½	3
D	35,000 to	50,000	- - - - - -	1½	2	2½	3
E	20,000 to	35,000	- - - - - -	2	2½	3	3½
F	10,000 to	20,000	- - - - - -	2½	3	3½	4
G	5,000 to	10,000	- - - - - -	3	3½	4	4½
H	3,000 to	5,000	- - - - - -	3	3½	4	4½
J	2,000 to	3,000	- - - - - -	3	3½	4	4½
K	1,000 to	2,000	- - - - - -	3	3½	4	4½
L	Up to	1,000	- - - - - -	3½	4	4½	5

CLASSIFICATION AS TO BOTH
ESTIMATED FINANCIAL STRENGTH AND CREDIT APPRAISAL

FINANCIAL STRENGTH BRACKET			EXPLANATION
1	$125,000 to	$1,000,000 and Over	When only the numeral (1, 2, 3, or 4) appears, it is an indication that the estimated financial strength, while not definitely classified, is presumed to be within the range of the ($) figures in the corresponding bracket and that a condition is believed to exist which warrants credit in keeping with that assumption.
2	20,000 to	125,000	
3	2,000 to	20,000	
4	Up to	2,000	

NOT CLASSIFIED OR ABSENCE OF RATING

The absence of a rating, expressed by the dash (—), is not to be construed as unfavorable but signifies circumstances difficult to classify within condensed rating symbols and should suggest to the subscriber the advisability of obtaining additional information.

gradual development from 1859, when the first key was published by B. Douglass & Co.[6] (later merged with R. G. Dun & Co.), to 1900, when the

[6] The original rating key published in 1859 was termed "Key to Markings." Eight different ratings were used, each rating representing the credit strength of a business. There was no rating representing the invested capital. Each concern, however, instead of receiving one rating as is customary today, received four ratings, one for each of four different types of concern which might use *The Reference Book*: (1) for bankers and buyers of single name paper, (2) for commission merchants, (3) for importers, manufacturers, and jobbers, and (4) a summary of merchants' and bankers' ratings. E. N. Vose, *Seventy-Five Years of The Mercantile Agency* (New York: R. G. Dun & Co., 1916), pp. 82–3.

present, more elaborate key was adopted. During the development of the rating key, the numeral came to have different meanings when allied with different capital ratings. For example, in "A + 1," the "1" represents good credit, while in "C + 1," the "1" represents high credit.

When a credit rating appears alone, as in "1," the numeral takes on a new significance. The rating "1" indicates that a concern has a pecuniary strength in excess of $125,000, but that no definite figures are available to classify the tangible net worth under any particular letter symbol. This rating indicates that available credit information is favorable, and that trade obligations are being retired most satisfactorily. The "2" rating carries a similar implication within the capital range of $20,000 to $125,000, "3," $2,000 to $20,000, and "4," less than $2,000.

Number of Names

The number of names contained in *The Reference Book* increased with minor fluctuations from 220,268 in 1859, the date the first *Reference Book* was published, to 2,212,000 in 1929. Since 1929 there has been considerable fluctuation, with an upward trend since 1944. The *Reference Book* as of July 1961 contained 2,632,000 names for the United States. These figures indicate the extent of the work involved in compiling, printing, and publishing *The Reference Book* six times each year.

Size of The Reference Book

The complete *Reference Book*, including full data on all names in the United States and Canada, is 11½ by 16½ inches and 4 inches thick and contains approximately 4,725 pages. Smaller reference books containing the same information on certain groups of states are available for business enterprises that sell in restricted territories. One volume contains data only on concerns located in the New England states, New Jersey, and New York, another on concerns located in the South Atlantic, East South Central, and West South Central states, as well as in the state of Missouri.

Individual state reference books are also published in "pocket" editions, 6¾ by 4¾ inches in size. "Pocket" editions are used largely as desk manuals by executives, and by traveling salesmen while on the road.

CREDIT CLEARING DIVISION

Many business enterprises—particularly those in the cutting-up divisions of the textile industry which transact business with thousands of accounts, and manufacturers that sell direct to retail stores—need expert credit de-

partments to follow the changing financial conditions of their widely scattered customers. Probably the most efficiently organized departments around the turn of the century were those of the New York City factors,[7] which at that time operated exclusively in the textile field. As a result of maintaining most up-to-date credit files and efficient personnel, their credit departments were able within a few minutes to pass upon almost any individual request for credit. These factors set the early pace for the development of keen specialization, in the understanding and interpretation of extensive information developed by thorough credit investigations and in the demand for comprehensive, up-to-the-minute current facts.

Mercantile houses which lacked pertinent credit information on many accounts, which even lacked the knowledge of what information was essential for sound credit interpretation, and which lacked experienced and qualified credit specialists had their troubles competitively around the turn of the century. Upon receipt, an order for merchandise would go to the credit department for its approval. The individual in the small concern who was responsible for, but not experienced or trained in, the sound extension of credit would thereupon order a credit report from one of the mercantile agencies, generally as the sole basis for his final decision. Unless the subscriber sent a special messenger, this report would generally be delivered early the following morning, and a final decision would be delayed until that time.

To eliminate this overnight delay, a new theory began to find expression in the textile industry about this time. If the concern receiving the

[7] The factor is essentially a specialized bank. Until the early 1930's they concentrated in financing textile (cotton, woolen, silk, and acetate) mills, selling agents, and converters, selling primarily to manufacturers of men's, women's and children's apparel, to department stores, and to chain stores, having extensive credit departments especially trained for this purpose. Since the early 1930's factors have financed more and more manufacturers and wholesalers in varied lines of business selling to retail stores. In its gradual evolution, the factor has come to have three distinct attributes: (1) advancing credit to its "accounts" against finished merchandise as security—that is, acting as a specialized bank; (2) passing upon the credits and in most cases cashing the sales—that is, buying the receivables outright without recourse; and (3) in some cases performing a group of special services, such as providing space for the display and the storage of merchandise, handling insurance, billing, packing, and shipping, and making city deliveries. The first and third of these attributes are clear. The second attribute of passing upon the credits and cashing the sales involves (*a*) passing upon the credit standing of concerns giving orders for merchandise at a moment's notice, so that the shipment of that merchandise can immediately be made, and (*b*) if the concern buying the merchandise becomes financially embarrassed or goes into bankruptcy, any credit loss on that particular account is assumed by the factor and not by the manufacturer or wholesaler (i.e., the "accounts") that shipped the merchandise. For a brief history of the evolution of factoring see Roy A. Foulke, *The Story of the Factor* (New York: Dun & Bradstreet, Inc., 1953).

order could telephone a central bureau and receive qualified advice immediately over the telephone, the order could be shipped or rejected without delay This theory was based upon two assumptions

1 That the concern receiving the order would be willing to accept and to follow the advice of such a bureau

2 That such a bureau would employ experts and have a continuous flow of pertinent information into its credit files, and so be in a better position than the concerns using its service to pass upon their daily requests for credit

This theory was gradually put into practice and developed, first in passing upon the current orders received by textile mills and selling agents from concerns in the cutting up trades—that is, from the manufacturers of cloaks and suits, waists and dresses, men's and children's clothing, shirts, and underwear from piece goods This initial development gradually expanded to the much larger field of serving the manufacturers of clothing selling direct to retail stores handling men's, women's, and children's clothing This evolution came to be known in credit circles as an "advisory credit service"

In 1928 R G Dun & Co organized a department, which has since become known as the Credit Clearing Division,[8] to give an advisory credit service to concerns everywhere in the United States selling to retail stores handling men's, women's, and children's clothing and accessories Approximately 160,000 retail concerns in the country handling wearing apparel and accessories, which are concentrated in and around the important cities, come under the daily attention of this division

Every three months this division publishes a specialized reference book known as the *Apparel Trades Book* This volume contains the names of all retailers of apparel in the United States, with symbols indicating the type of apparel and accessories sold, and their respective credit rating based on a specialized rating key (Figure 16) This volume consists of approximately fourteen hundred pages, each page, 11 by 15 inches, containing three columns of names with trade styles and appropriate ratings.

MUNICIPAL SERVICE DEPARTMENT

The Municipal Service Department prepares specialized investment reports on states, counties, cities, and other governmental units for com-

[8] The style "Credit Clearing Division" was adopted in 1942 when Dun & Bradstreet, Inc acquired the business of the Credit Clearing House, Inc, New York City, a specialized credit agency which had been organized in St Paul, Minn., in 1888 The Credit Clearing House, Inc, had originated advisory credit service in 1915, and this then became its primary activity

Figure 16 Rating Key, Credit Clearing Division of Dun & Bradstreet, Inc.

RATING KEY

SUBSCRIBERS ARE WARNED to consult the detail reports in our possession in every case involving credit Reasonable prudence requires that this be done The date of this book is that of its publication It was compiled before that date Many changes in names and ratings are made each business day. Also the work is so vast that other causes of error are not and cannot always be avoided Hence we assume no responsibility to subscribers for the correctness of the ratings herein

	ESTIMATED FINANCIAL STRENGTH			PAYMENTS APPRAISAL				COMPOSITE APPRAISAL			
*B-	A	Over	$1,000,000	1	2	3	4	A	B	C	D
*B-	- - - - - See Note[1] - - - - - - - - -			1	2	3	4	A	B	C	D
*B-	C	Over	500,000	1	2	3	4	A	B	C	D
*F-	D	Over	300,000	1	2	3	4	A	B	C	D
*F-	E	Over	200,000	1	2	3	4	A	B	C	D
*F-	- - - - - See Note[1] - - - - - - - - -			1	2	3	4	A	B	C	D
*F-	G	Over	100,000	1	2	3	4	A	B	C	D
*K-	H	Over	50,000	1	2	3	4	A	B	C	D
*K-	J	Over	30,000	1	2	3	4	A	B	C	D
*K-	- - - - - See Note[1] - - - - - - - - -			1	2	3	4	A	B	C	D
*K-	L	Over	20,000	1	2	3	4	A	B	C	D
*K-	M	Over	10,000	1	2	3	4	A	B	C	D
*S-	O	Over	5,000	1	2	3	4	A	B	C	D
*S-	R	Over	3,000	1	2	3	4	A	B	C	D
*S-	- - - - - See Note[1] - - - - - - -			1	2	3	4	A	B	C	D
*S-	T	Over	2,000	1	2	3	4	A	B	C	D
*S-	V	Over	1,000	1	2	3	4	A	B	C	D
	W	Up to	1,000	1	2	3	4	A	B	C	D
	X	{Not Classified See Note[2]}		X {Not Classified See Note[2]}				X {Not Classified See Note[2]}			

§ {The symbol § preceding a rating indicates that an important part of the total worth consists of real estate or other assets not usually considered working capital

Note[1] {The letters B, F, K, and S in the Estimated Financial Strength column preceded by the symbol *, indicate in a general way what is considered relative in size To illustrate the letter B indicates size comparable to concerns classified in the range A to C inclusive, the letter F, comparable to those from D to G inclusive, the letter K, comparable to those from H to M inclusive, and the letter S comparable to those from O to V inclusive

Note[2] {The letter x is not to be construed as unfavorable but, in the column or columns in which used, signifies circumstances difficult to definitely classify within condensed rating symbols and should suggest to the subscriber the advisability of reading the detailed report.

ESTIMATED FINANCIAL STRENGTH

In Estimating Financial Strength all assets may not be given equal weight. The weight given to assets is dependent upon their nature and availability If any assets are not given full weight but are deemed to add strength, due consideration is given to them in the "Composite Appraisal"

PAYMENTS APPRAISAL

Payments Appraisal classifications are relative and based primarily upon the manner of meeting trade obligations with respect to punctuality and attitude Gradation is influenced by the promptness of trade payments but application is sufficiently flexible to allow for other elements of significance

COMPOSITE APPRAISAL

The Composite Appraisal takes into consideration all significant elements of credit Such classification is relative and predicated principally upon the broad and over-all viewpoint.

mercial banks and trust companies, savings banks, investment bankers, financial institutions, insurance companies, private estates, and individual investors having substantial commitments in municipal securities

Description of a Municipal Report

Each basic municipal report issued by the department consists of four statistical pages containing pertinent figures and facts on the character, government, and financial operations of the unit covered These data are supplemented and explained in detail in the narrative section of the report, which gives a running story of the financial progress and prospects of the community This latter section usually averages from six to eight pages, but not infrequently ranges from ten to fifteen in more involved cases In a few instances such as New York City,[9] Chicago, Detroit, and Miami, the basic survey may consist of forty to fifty pages

To many subscribers the most important page in the entire analysis is the first page, known as the Summary " Here, in brief, are presented the most essential figures and revealing comments on the credit status of a community Each of the four specific considerations of (*a*) economic and social factors, (*b*) administration, (*c*) debt obligations, and (*d*) current operations are concisely summarized and classified as "favorable," "fair," or 'unfavorable At the bottom of this page is a terse paragraph summarizing the present state of and giving a forecast of the community's credit Thus, the Summary reveals at a glance a clear picture of the financial standing of the community and a definite indication of its trend In amplification and support of the conclusions that appear on the first page, a mass of verifying and interpretative material follows in the narrative section

From time to time brief follow-up reports, known as 'Supplements,' are issued These review and summarize later financial data and note any significant changes, developments, or trends in the finances of a given situation since the preparation of the basic survey

Units on Which Reports are Compiled

Reports are issued as and when any state, county, city, school district, or other borrowing unit publicly sells a single issue of general obligation

[9] The histories of municipalities have also at times involved financial incidents not quite so prosaic as defaults on long term obligations Denis T Lynch has drawn a dramatic picture of one of these unusual situations, in which the City Hall in New York City was auctioned off by the sheriff to meet a city obligation in October 1858 See Lynch, "*Boss*" *Tweed* (New York Liveright Publishing Corp., 1927), pp 209-10

bonds of $750,000 or over, maturing in more than one year. A complete basic report and a supplementary report are also issued yearly on three hundred major governmental units, including the borrowing states, larger cities, counties, and special taxing districts throughout the country regardless of whether they sell or do not sell any new bonds.[10] Reports are likewise prepared on fifty of the larger publicly operated revenue-bond projects and authorities when any of the fifty authorities sells a new bond issue of $750,000 or more at public sale. Among such units are the Port of New York Authority, the Triborough Bridge Authority, the New Jersey, Pennsylvania and Maine Turnpike Authorities, and municipally operated water, electric, and gas departments. These revenue surveys present a complete analysis and evaluation of the present and future outlook for such revenue projects, with special emphasis on growth prospects. This service is supplemented by special monthly and quarterly reports on earnings and traffic trends of major turnpikes and other vehicular toll facilities.

INTERNATIONAL DIVISION

Three years before the outbreak of the Civil War, R. G. Dun & Co. started its chain of foreign offices by establishing two branches, one at London, England, and the other at Montreal, Canada. The London office was opened because the New York office already had as clients a number of the leading export houses in the United Kingdom.

At the outset the London branch confined its relations to export and import houses trading between the two countries, but soon the business community in Great Britain began to call for reports on British as well as American traders. In 1872 branches were established in Glasgow, Scotland, and Paris, France; in 1876, in Leipzig, Germany; in 1887, in Melbourne, Australia. In the immediately succeeding years resident agents

[10] Twelve states either have no general obligation bonds or have only a negligible amount. They are Arizona, Colorado, Florida, Georgia, Indiana, Kansas, Nebraska, Nevada, South Dakota, Utah, Wisconsin, and Wyoming. However, including, in addition to general obligation bonds, limited obligations and non-guaranteed or revenue bonds of state agencies, each of the fifty states has some long-term debt. Limited obligation and non-guaranteed debt is most commonly used for state institutions, particularly institutions of higher education, and for highways, while revenue bonds have come into widespread use in the postward period for financing toll highways, usually through a semi-autonomous state commission or authority. The gross long-term debt of the fifty states on June 30, 1961, including both full faith and credit and non-guaranteed debt, was $19,529,000,000 according to the Division of Governments of the Bureau of the Census, and the net long-term debt was $16,664,000,000. The gross long-term state and local debt combined, as of June 30, 1960, was $66,801,000,000, a new peak.

were appointed in the other business centers in Australia and New Zealand Additional branches were subsequently installed in Europe, South Africa, South America, Mexico, and the West Indies At the present time there are sixty-four offices in twenty foreign countries, not including the Dominion of Canada, serving as direct branches of the subsidiaries and affiliates of Dun & Bradstreet, Inc

These facilities are available, in accordance with the customs of each particular country, to American bankers, manufacturers, and exporters. Credit information is based upon a thorough investigation *at the source* supplemented by comprehensive investigations in the American market and in any foreign markets in which the debtor might be purchasing merchandise or obtaining bank credit These credit facilities of the world are funneled into the International Division of Dun & Bradstreet, Inc, in New York City

Credit reports are edited in the New York office on practically all foreign names A staff of specialists keep in touch with the respective markets and their conditions and translate correspondence and reports received from foreign countries Reports are modeled after the domestic reports In each report, as complete a picture as possible is given of the history of the business since its inception Under "Method of Operation" comes a description of the business, lines of merchandise handled, and agencies held Available financial statements are included for comparative purposes The customary trade investigation shows the lines of credit recently allowed and payment records throughout the world There is also included a current quotation, in dollars, of the foreign currency used in the report Thus, at a glance the banker or the credit man sees the approximate equivalent in United States currency of his client's capital, whether the statement be in Argentine pesos, Brazilian contos, Venezuelan bolivars, or Japanese yen

The International Division publishes three reference books yearly The New York office publishes the *Latin America Market Guide,* consisting of three volumes, in English Volume I covers Cuba, Puerto Rico, and the other West Indian islands, Volume II covers the South American countries (Argentina, Bolivia, Brazil, British Guiana, Chile, Colombia, Ecuador, French Guiana, Paraguay, Peru, Surinam, Uruguay, and Venezuela), and Volume III covers Mexico and Central America. The *Latin America Market Guide* contains coded information on manufacturers, wholesalers, retailers, sales agents, and service organizations Each listing includes the name and address of the concern, line of business, estimated capital, and pay code The Rio de Janeiro office publishes *Sinopsis Dun,* which in

effect is a complete reference book for Brazil. The Mexico City office publishes *Sinopsis Dun,* a complete reference book for Mexico.

MERCANTILE CLAIMS DIVISION

Since 1841 the Mercantile Claims Division has assisted in collecting past due accounts arising out of mercantile transactions. This division is designed to render a practical collection service on past due "commercial" accounts (as distinguished from "retail" or "consumer" accounts). Activities connected with adjustments, assignments, receiverships, or bankruptcies are beyond the scope of its activities.

This service is rendered on the basis of an annual subscription agreement and the payment of a minimum annual service charge, for which the subscriber receives, at no extra cost to him, the first two steps in the service. These are "Reminder Service," consisting of two kinds of gummed reminders which subscribers may use on their past due statements and letters, and "Free Demand Service," which is a written request for payment sent to the debtor by the Mercantile Claims Division. Many accounts are collected through these first two steps in the service, and there are no charges for these collections above the minimum annual service charge.

Accounts not collected through either of the first two steps are subject to a graduated scale of contingent collection commissions if they are collected in subsequent steps in the service.

MARKETING SERVICES COMPANY DIVISION

The Marketing Services Company Division operates as a marketing research agency, serving individual businesses, trade associations and groups interested in particular problems. Survey planning, supervision, and analyses are performed by a professional staff of marketing specialists. This group of analysts draws on available authoritative information sources and directs field survey activities carried out by the Dun & Bradstreet field organization. It prepares surveys on a wide range of subjects such as industry appraisals, sales potentials, distribution methods, product acceptance, corporate image analysis, trade and customer attitude, prospect identification, purchase-decision factor analysis, industry statistics and trade association services, and cost of doing business surveys.

In 1959 the annual publication of a *Million Dollar Directory* was instituted. This publication, with interim supplements, lists over twenty-one thousand corporations with a net worth in excess of $1,000,000. Included

in each listing are the names of management personnel, type of business operation, annual sales, and number of employees The directory is divided into four sections—businesses listed alphabetically, geographically, and by line of activity, and names of officers and directors—providing for maximum utility in sales, marketing purchasing, and identification

In 1960 the *Metalworking Directory* was initiated This directory lists thirty thousand metalworking plants employing more than twenty persons Data for each plant include name, address, products produced or services rendered, standard industrial classification codes, number of employees, and names of persons in charge of general management, purchasing, production, and engineering Information is arranged in geographical order by states and towns Other sections list plants alphabetically and by line of business In addition, there is a statistical section by counties, showing the number of plants of various sizes with each industrial classification A "how-to" section details the way in which the directory may be used to perform marketing analysis from measuring potentials to locating and evaluating specific prospects

MAGAZINE DIVISION

In 1893 *Dun's Review* was established as a weekly journal of finance, trade, and business conditions This magazine furnishes commerce and industry with a summary of business conditions in the various parts of the United States and in various lines of business activity Through this medium, bankers, business executives, and students of business affairs are currently apprised of the number and aggregate liabilities of business failures Failure statistics are broken down by lines of business, geographical location, and size of liabilities The magazine also carries weekly and monthly compilations of bank clearings, a monthly record of building permits, and other studies and summaries of business facts and operations of current interest to men of affairs

In April 1933 the magazine was changed from a weekly to a monthly The monthly has continued most of the features of the weekly and has added timely articles by men of national reputation and by the research staff of the Dun & Bradstreet organization These articles cover such subjects as the probable effect of current legislation, tax policies of the Federal government, financial ratios as measures of managerial policies, and average expenses of retail enterprises In 1953 *Modern Industry* was acquired, and the name was changed to *Dun's Review and Modern Industry*.

chapter V

SPECIALIZED MERCANTILE AGENCIES

IN THE WHOLESALE GROCERY TRADE THERE ARE ELEVEN DIFFERENT recognized types of concern engaged in the intermediate distribution of merchandise. These types vary from the typical service wholesale organization which maintains a warehouse and delivery system and has an established clientele of retail grocers, to those concerns whose activities are so highly specialized that they are known as institutional wholesalers, voluntary group wholesalers, desk jobbers, or wagon jobbers. This specialization has found its way into every conceivable line of commercial, industrial, and professional activity. A dentist can make a reputation for the exactness of his inlays, a surgeon for removing warts, Walt Disney for Donald Duck and Mickey Mouse, and an architect for designing compact Cape Cod cottages.

This same specialization has found its way into the investigation of the credit responsibilities of business enterprises in certain restricted fields of business activity. As outlined in the preceding chapter, the nationwide organization of Dun & Bradstreet, Inc., has achieved a high degree of specialization at those points where credit investigations and analyses have been divided by lines of business among reporters with special aptitude, training, and experience.

Among the smaller mercantile agencies specialization is the outstanding attribute. The Produce Reporter Co. specializes in the preparation of credit reports on wholesale handlers of fresh fruits and vegetables. Lumberman's Credit Association, Inc., specializes in the investigation, analysis, and editing of credit reports on all manufacturers, wholesalers, and retailers in the furniture and woodworking industries; the Jewelers

Board of Trade, on all concerns in the jewelry, diamond, silverware, and precious stone trades, Lyon Furniture Mercantile Agency, on the furniture and allied trades, and the National Credit Office, Inc, on editing reports on the manufacturers and purchasers at wholesale of textiles and textile products, furniture, rubber products, leather products, steel and steel products, and on all concerns that sell their commercial paper in the open market

In the following pages we shall describe the specialized mercantile agencies and the supplementary services by breaking them down into four groups

1 Specialized mercantile agencies that report upon business enterprises, including six of the more important agencies—namely, the National Credit Office, Inc, Lyon Furniture Mercantile Agency, the Jewelers Board of Trade, Lumberman's Credit Association, Inc, the Produce Reporter Co., and the National Association of Credit Management

2 Specialized agencies that report primarily upon individuals, including the Hooper-Holmes Bureau, Inc, and the Retail Credit Company

3 Specialized agencies that make special investigations of business enterprises and individuals, including Proudfoot's Commercial Agency, Inc, Bishop's Service, Inc, and Hill's Reports, Inc

4 Supplementary service organizations of fundamental interest to banking institutions, including Moody's Investors Service, Inc, Standard & Poor's Corporation, and Alfred M Best Company, Inc

ADVANTAGES AND DISADVANTAGES

There are three apparent differences between the activities of general and specialized mercantile agencies two have to do with the methods of operation, and one, with credit service from the viewpoint of the subscriber

Direct Calls

The two differences in method of operation involve (*a*) the mechanics of obtaining direct information, and (*b*) the specialized experience and knowledge of the reporter who gathers, analyzes, and edits the final report The national service of Dun & Bradstreet, Inc, is so arranged that a representative calls directly upon an operating official of every commercial and industrial business enterprise in the United States at least once every year, verifies the names of the principals, obtains a current financial statement whenever available, verifies the method of

operation of the enterprise, and also obtains a current list of trade creditors. Specialized agencies, with one or a very few offices, lack national coverage. Accordingly, they must obtain information on a concern located at a distance by correspondence either directly with the concern or with a local attorney, or trust to their ability to obtain part of this information from near-by subscribers.

Specialized Training

The second difference has to do with the knowledge, training, and specialized credit background of the reporter. Specialized mercantile agencies claim that they have to a unique degree the opportunity to train reporters in the intimacies of the trades in which they operate. Their reporters become acquainted not only with the regular and normal manner in which business is conducted in the lines of commercial and industrial activity that come under their daily scrutiny, but also with the personalities and backgrounds of the men who operate individual businesses. If the usual terms for purchasing merchandise are four months and a concern is buying on sixty-day terms, that is a clear signal to investigate and ascertain why. If a concern is turning its merchandise three times each year and competitors are turning theirs five times, something is wrong. If the gross profit of a business is only 15 per cent and near-by competitors are getting 23 per cent, some item of expense must be excessive. If a concern places orders for merchandise with a large number of suppliers from which it has never purchased merchandise before, an immediate investigation will probably indicate that it is "buying for a bust." If the proprietor of a moderate-sized business buys a new pretentious residence when it is known he can carry a large mortgage only with difficulty, it's time to have a heart-to-heart talk with him. Such intimate details become familiar to the specialist and are of infinite value to him in keeping in touch with developments of business enterprises within a specialized line of business. The same information, however, is also available to the skilled reporter who handles a specialized division for a general agency.

A specialized reporter also keeps in close touch with conditions in his line. If the price of lumber, cotton, or any other raw material begins to skyrocket or to drop, he goes over his accounts to judge what effect a continuation of that trend might have upon certain business units in his field. If sales begin to fall off nationally, the information comes to his ears without much loss of time, and he correlates that knowledge with the

heavy or the light inventories of certain concerns If a flood occurs, he knows what accounts are selling heavily in that market This detailed knowledge of conditions does at times assist in reporting more accurately upon key accounts

From the Point of View of the Banker

The third difference between the general and specialized agencies has to do with service from the viewpoint of the subscriber A general mercantile agency prepares credit reports on concerns in all lines of business in all parts of the country A bank of moderate size is able to obtain credit service on all accounts from the general agency If a bank were to use specialized agencies exclusively, subscriptions to several services would be required, and even then many lines of business activity would not be covered by any one of them Furthermore, in those lines of business activity where a specialized agency is not unusually strong, the general agency, because of its established prestige and reputation, may be able to obtain a greater amount of essential credit data, particularly as a personal call is always made

SPECIALIZED MERCANTILE AGENCIES REPORTING UPON BUSINESS ENTERPRISES

The measure of utility in the capitalistic business world is the ability to show a profit That urge produced the entrepreneurs who made their fortunes building and promoting railroad lines, the telephone system, electric power generating and distributing units, farm equipment, automobiles and investment trusts Specialized mercantile agencies, likewise, generally were started and have been operated with a profit motive The Jewelers Board of Trade, a mutual organization, is an exception

No way has been found whereby a specialized mercantile agency can handle efficiently and at a profit the thorough investigation and preparation of comprehensive credit reports on the hundreds of thousands of small retailers situated in outlying country towns, villages, and hamlets throughout the country As a result, specialized agencies have tended to confine their activities to those lines of business which are generally concentrated in one place and in which there is normally a turnover of reports, that is, where several inquiries on a business enterprise may be answered simultaneously with the same report These two conditions have been essential to the success of the specialized agencies, just as assembly-line production is essential to the automobile business Thus, the National

Credit Office, Inc., came into existence in New York City, where are concentrated the cutting-up, or needle, trades; the Lumberman's Credit Association, Inc., in Chicago; and the other specialized agencies to be discussed, in particular commercial or industrial centers.

National Credit Office, Inc.

The National Credit Office, Inc., became affiliated with Dun & Bradstreet, Inc., in 1931, when both enterprises were taken over by the same holding company.[1] The agency's staff of highly trained and specialized reporters make their own comprehensive credit investigations, prepare their distinctive specialized credit reports, and render services fitted to the peculiar needs of the industries served. The headquarters of the National Credit Office, Inc., are located in New York City, with branch offices in Atlanta, Boston, Chicago, Cleveland, Detroit, Philadelphia, and Los Angeles.

Organized in 1900, this agency has grown from a relatively inconspicuous start to the largest specialized mercantile credit agency in the country, offering comprehensive services on manufacturers, converters, assemblers, exporters, and wholesalers in the lines of industry given in the outline on pages 97 to 99. The only retail concerns covered are (*a*) department stores, (*b*) chain stores in the respective industries in which this agency operates, and (*c*) larger furniture stores. In other words, the fields covered consist of the successive stages of handling, converting, and manufacturing and then wholesaling products in the particular industries.

The National Credit Office, Inc., originally investigated only concerns in the cutting-up, or needle, trades of the textile industry—wholesalers and jobbers that purchased cotton, silk, woolen, and worsted piece goods and produced men's, women's, and children's finished underwear and outer garments for distribution to the retail trade. Around 1920 the business began to expand, and since that date departments have gradually been developed to handle the investigations and prepare credit reports on businesses in the following lines of activity:

A. Concerns in all lines offering their commercial paper on the open market.

B. Textiles

1. Men's wear: Manufacturers of men's and boys' tailored clothing,

[1] Then the R. G. Dun Corporation. The name of this corporation was changed in 1933 to the R. G. Dun-Bradstreet Corporation and in 1939 to Dun & Bradstreet, Inc.

jackets, slacks, casual wear, shirts, pajamas, underwear, robes, sports wear, work clothing, uniforms, rain wear, fabric hats and caps, and jobbers of men's-wear fabrics and trimmings.

2 Dresses and sports wear Manufacturers of dresses, blouses, skirts, sports wear, bathing suits, infants and girls' wear, housecoats, aprons, nurses and maids' uniforms, dolls and stuffed toys

3 Coats, suits, and intimate apparel Manufacturers of coats, suits, sports wear, skirts, rain wear, children's coats and snowsuits, lingerie, negligees, corsets, brassieres, bed jackets and robes, neck wear, laces, embroideries and miscellaneous products, and jobbers of women's wear fabrics

4 Textile mills Dealers, processors, and jobbers of yarns, threads, twines, and raw materials, weavers and knitters of woolens and worsteds, manufacturers of synthetic, cotton, and blended fabrics, laces, braids, felts, bonded fabrics, rugs, and carpeting, knitters of hosiery, underwear, and outer wear; and dyers, bleachers, finishers, and printers of textiles

5 Converting, household, and industrial goods Converters of cotton, synthetic, silk, other fabrics and coaters of textiles, manufacturers of curtains, bedspreads, drapes, industrial bags, work clothes, seat covers, coat fronts, shoulder pads quilted products, bias bindings, allied accessories, handkerchiefs, tablecloths, sheets, pillow cases, upholstered furniture, mattresses, and jobbers of upholstery fabrics

6 Wholesale and retail Jobbers of hosiery, underwear, knit goods, and dry goods, jobbers and exporters of cotton, rayon, and synthetic fabrics, department stores chain stores, discount houses, and other retailers handling piece goods, dry goods, knit goods, and floor coverings

C. Leather and Coated Products

1 Footwear Manufacturers of shoes and slippers

2 Shoe Components Manufacturers of leather heels, soles, and trimmings

3 Handbags Manufacturers of handbags and purses

4 Luggage Manufacturers of trunks, suitcases, and brief cases

5 Accessories Manufacturers of leather and plastic garments and gloves, belts, wallets, key cases, and similar products

D Electronics

1 Manufacturers of radio and television sets, components, electronic, atomic, and nucleonic equipment.

2 Manufacturers of electrical machinery, equipment and parts

3 Distributors of electronic parts

E. Metals

1. Aeronautical Manufacturers of airplanes, engines, missiles, instru

ments, electronic guidance and control systems, parts, and equipment; and airlines.

2. Appliances: Manufacturers of household, office, and industrial appliances; heating, ventilating, refrigeration, and air-conditioning equipment.

3. Automotive: Manufacturers of motor vehicles, trailers, bodies, engines, accessories, and parts.

4. Machinery: Manufacturers of farming, electrical, road-building, construction, metalworking, textile, and other machinery, and mechanical equipment.

5. Metal products: Manufacturers of castings, forgings, stampings, and screw-machine products; and shipbuilding.

F. Chemicals

1. Paints: Manufacturers of paints, varnishes, enamels, lacquers, and synthetic resins.

2. Inks: Manufacturers of printing inks.

3. Rubber: Manufacturers of tires, tubes, mechanical goods, and rubber products.

Distinctive credit reports are prepared and regularly brought up to date on every concern in the United States which operates in these fields. Every credit report carries a summary of the credit responsibility of the subject. If the concern is in satisfactory financial condition, a definite suggestion is made regarding the average amount of credit to be extended by merchandise suppliers. No suggestion for credit is made, however, if the concern is a marginal enterprise. Suggestions for credit are changed as often as necessary, occasionally several times yearly. Practically every important concern selling to the lines of business mentioned is a subscriber to the service, so that the coverage is unusually complete. Typical divisions of the service are described in the following paragraphs.

Bank Service.—"Open market commercial paper" describes the short-term promissory notes of a corporation sold to banks, corporations, pension funds, colleges, and others having excess funds for temporary investment. Some notes are sold through the medium of commercial paper dealers, and some direct by the issuing corporations.

The Bank Service Division investigates, analyzes, and edits specialized reports on all corporations selling their commercial paper in that open market. These corporations are located in every state in the Union and have a tangible net worth that rarely goes below $500,000 and at times exceeds $250,000,000. They operate in all important divisions of commerce and industry and certain areas of finance.

This service is utilized by large city banks that are interested in all open-

market borrowers, not only as sources of investment for the banks' own accounts and the accounts of correspondents, but also because open-market borrowers are prospective depositors. Smaller city and "country" banks which invest part of their secondary reserves in short-term, self-liquidating commercial paper also subscribe to the service. The reports prepared by this department are exceptionally thorough and comprehensive on all phases of a credit risk. The first page contains the classification of the note in one of the following five categories: "Prime," "Desirable," "Satisfactory," "Fair," and "Not Recommended." No reference book is published by this division. Then follows the name of the commercial paper dealer, a list of the principal banks of account of the company, information regarding bank relations—such as total lines of credit available, the amount currently in use, and comment by the company's banks regarding the account.

This information is followed by an analysis of the three latest comparative balance sheets, together with sales, profits, and dividends. Comment is made regarding size and trend of debt position, inventories, receivables, and fixed assets. Working capital is reconciled, and a summary of sales, earnings, dividends, and net worth is presented for the past fifteen years. Next follows a record of the officers and business itself, a description of the concern's operating methods, the names of any subsidiary or affiliated concerns, and an explanation of any intercompany loans or intercompany merchandise sales.

Textiles—Each of the six divisions of this department is under the direction of an experienced industry manager, who is responsible for the quality, speed, and thoroughness of the reports in his division.

The typical report starts off with the name of the concern, its address, and the names of the officers or the principals at interest. Then follows a brief synopsis giving the high points of the record of the principals; the trend of the business, its summarized current financial condition and trend, a current detailed trade investigation; names of the important sources of supply, analysis of record and financial condition, ending with the suggested definite line of credit. The second page gives a full business record of the principals and the business, a description of the method of operation, and the name of the depository bank or banks. Next appears a photostatic copy of the latest available balance sheet, generally on a standard form. Necessary supplemental details are included to explain unusual items.

All divisions of the cutting-up trade have seasonal operations, with spring and fall peaks. A manufacturer of popular-priced ladies' silk

and acetate dresses may, for example, issue a financial statement on June 30 or December 31 showing practically no liabilities. Three months later at the peak of manufacturing operations, however, a balance sheet may frequently show liabilities several times the amount of the tangible net worth. Concerns in this field generally operate at a small profit and aim at large sales volume. Every season some businesses miss the current styles, find difficulty in marketing their output rapidly enough to meet maturing obligations, finally sell their accumulated inventories at a loss, and voluntarily go into bankruptcy or liquidate. Consequently this department must keep in touch with competitive gossip and purchase and sales trends and note any little peculiarity, such as selling noticeably below the market in season, which often indicates to the trained mind that a concern is more extended financially than it should be.

No reference book is published by the Textile Department. Unlike the service of Dun & Bradstreet, Inc., no ratings are used. Each report contains a summary in which a specific line of credit—such as $1,000, $2,500, $5,000, requirements—or none at all is suggested. In theory the amount of credit suggested is determined by dividing the normal seasonal purchase requirements of a concern by the number of its merchandise suppliers; that is, a concern that would normally purchase $90,000 in piece goods each season from thirty distributors, would receive an average line of $3,000.

Concerns needing a particularly fancy printed material may buy piece goods from a limited number of converters; other concerns with extensive lines of suits or dresses in various price ranges may purchase materials from thirty or forty houses. The distribution of purchases must therefore be taken into consideration. This distribution depends not only on the construction, style, and price range of the piece goods needed, but also upon personal relationships, which, after all, go a long way in business.

Leather and Coated Products.—This division's reports on all manufacturers of leather and plastic products are similar to those issued by the Textile Department. Data are kept constantly up to date.

Electronics, Metals, and Chemicals.—These divisions are an outgrowth of the Credographic Bureau of Cleveland, a specialized agency which for many years published a monthly credit-rating book. This bureau was taken over by the National Credit Office, Inc., in 1923 and has steadily expanded to cover the lines in these areas listed on pages 98–99.

Supervisors are in charge of each division of the Electronics, Metals, and Chemicals divisions. They are responsible for the final editing of the specialized reports, the summaries, intimate knowledge of changing busi-

ness conditions in their respective lines of activity, and the investigation of all rumors The one fundamental difference between the Electronics Department and all others is that it publishes monthly a reference book with ratings, one section covers manufacturers of automotive, aeronautical, electrical, electronic, and metal products, and the other, distributors of radio and electronic products and parts The reference book is utilized not only for credit reference purposes, but also as leads for the sales divisions of subscribers Each volume has information on every concern in the United States in its particular division of industry, they contain not only a credit rating but also valuable supplementary data These books are in a looseleaf form

Supplementary Departments—The primary function of the National Credit Office, Inc., is the thorough, periodic investigation, analysis, and editing of comprehensive credit reports by trained specialists and the extending of credit advice to its subscribers in the selected lines of industry and commerce Other specialized services, however, have been developed to be of supplemental assistance to the business world Among these are Participation in Credit Groups, Specialized Claims Division, Consulting Service, Market Planning Service, the Mobile Homes Credit Guide, and the Electronic Marketing Directory

Lyon Furniture Mercantile Agency

Organized in 1876, this specialized agency reports upon the manufacturers, wholesalers, and retailers of furniture, carpets, floor coverings, upholstery, lamps, mirrors, baby carriages, refrigerators, and undertaking establishments in the United States Headquarters are maintained in New York City, and branch offices are in six key cities in the furniture trades—Chicago, Illinois, Hight Point, North Carolina, Cincinnati, Ohio; Los Angeles, California, Boston, Massachusetts, and Philadelphia, Pennsylvania. The reports are edited by specialists who keep in touch with respective divisions of the furniture industry

The credit reports give a careful business record of each of the officers of a concern, the history of the concern itself, a comparison of the size of assets, liabilities, and net worth for several years, a copy of the latest financial statement, with a brief interpretation of the figures, recent trade experiences, collection record, if any, a summary of the highlights in the report, and a rating

Rating Book—A reference book is issued semi annually, in January and July In the trade it is known by its color as the *Red Book* The ratings

are similar in form to the general agency ratings, except that they also give a pay rating and a large number of special ratings. Figure 17A on this page shows the Lyon *Red Book* Credit Key, on the reverse side of which (Figure 17B, page 104), are continued the numeral ratings for

Figure 17A Credit Key Used in Lyon *Red Book*

LYON RED BOOK—CREDIT KEY

CAPITAL RATINGS
Estimated Financial Worth

A	$1,000,000	or	over
B	500,000	to	$1,000,000
C	300,000	to	500,000
D	200,000	to	300,000
E	100,000	to	200,000
G	75,000	to	100,000
H	50,000	to	75,000
J	40,000	to	50,000
K	30,000	to	40,000
L	20,000	to	30,000
M	15,000	to	20,000
N	10,000	to	15,000
O	7,000	to	10,000
Q	5,000	to	7,000
R	3,000	to	5,000
S	2,000	to	3,000
T	1,000	to	2,000
U	500	to	1,000
V	100	to	500

Z-No financial basis for credit reported.

INDEFINITE RATINGS

F —Estimated financial responsibility not definitely determined, presumed high.

P —Estimated financial responsibility not definitely determined, presumed moderate.

W—Estimated financial responsibility not definitely determined, presumed small.

Y —Estimated financial responsibility not definitely determined, presumed very limited.

The omission of a rating is not unfavorable, but indicates that sufficient information is not at hand on which to base rating.

PAY RATINGS
Based on suppliers' reports

1—Discount.
2—Prompt.
3—Medium.
4—*Variable, prompt to slow*
5—Slow.
6—Very slow.
7—C. O. D. or C. B. D.

8—Pay rating not established, but information favorable.
9—Claims to buy always for cash.

SPECIAL CONDITIONS

12—Business recently commenced.
13—Inquire for report.
21—Buys small, usually pays cash.
23—*Sells on commission.*
24—Name listed for convenience only.
29—Rating undetermined.
31—Financial statement declined, or repeatedly requested and not received.

SYMBOL INTERPRETATION

● or 12 — Business recently commenced.
+ or 116 —New statement recently *received.*
▲ – Indicates information of unusual *importance.*
O—Sells on installment plan.
(?)—Sells from residence, office or catalogue.

CREDIT GRANTORS-NOTE

No system of ratings can ALWAYS convey an accurate summarization of existing conditions. Book ratings reflect conditions believed to exist when assigned, and are based upon information obtained from financial statements, from the trade, special reporters, correspondents, financial institutions and other sources deemed reliable, but the correctness thereof is in no way guaranteed.

Conditions are constantly changing, and changes as made are shown in the "LYON Weekly Supplement and Report", and in Lyon Credit Reports.

Should any error, or inaccuracy in rating be noted, it should be reported only to the Agency, in order that correction may be made.

Inquire for Detailed Credit Report on all NEW ACCOUNTS, and make inquiry at least once a year on old accounts or when change in rating is indicated in the "LYON Weekly Supplement and Report".

Figure 17B Special Ratings Used in Lyon *Red Book* (*reverse*)

SPECIAL RATINGS

Key Numbers interpreting Credit Items and Business Conditions, as appear in

LYON WEEKLY SUPPLEMENT AND REPORT

12 or ●—Business recently commenced.
13—Inquire for report.
21—Buys small usually pays cash.
23—Sells on commission.
24—Name listed for convenience only
29—Rating undetermined.
30—Rating in abeyance pending later information.
31—Financial statement declined or repeatedly requested and not received
47—New ownership or change in ownership.
49—Dissolved.
50—Succeeded by —
51—Rating raised to —
52—Rating lowered to —
54—Rating suspended
55—Given bill of sale or notice thereof
56—Reported selling out or discontinuing
57—Have sold out
58—Sold out at auction.
59—Damaged by water
60—Damaged by flood or storm.
61—Damaged by fire.
62—Burned out.
63—Partially insured.
64—Fully insured.
65—Inventory not insured.
66—No insurance.
67—Will continue.
68—Deceased
69—Estate continues.
70—Claim placed for collection with Lyon Agency
75—Suit reported.
76—Execution issued
77—Judgment reported
78—Attachment proceedings reported.
79—Closed by Sheriff or Marshal.
80—Sold out by Sheriff or Marshal.
81—Chattel mortgage
82—Chattel mortgage foreclosed.
83—Deed of trust for benefit of creditors.
85—Real estate mortgage foreclosed.
87—Assignment for benefit of creditors.
88—Petition for Receiver filed
89—Temporary Receiver appointed.
90—Receiver appointed.
91—In hands of Receiver
92—Voluntary petition in bankruptcy
93—Involuntary petition in bankruptcy
94—Petition for arrangement reorganization extension or composition.
95—In bankruptcy
96—Inquire for important new report.
98—Trustee appointed.
99—In liquidation to discontinue business.
100—First dividend paid.
101—Second dividend paid.
102—Final dividend paid
103—Asking extension
104—Called meeting of creditors.
105—Offering to compromise.
106—Unable to locate.
107—Discontinued or out of business.
108—Claims should be given immediate attention.
109—Settled and resumed
110—Settlement paid
111—Removed to —
113—Capital stock increased to —
114—Name changed to —
115—Cannot report definitely as yet.
116 or ✚—New statement recently received
117—Received discharge in bankruptcy
118—Discharge in bankruptcy denied.
119—Not for book listing.
120—Discontinue book listing.

special situations. The service also includes a weekly report and supplement to the *Red Book*, containing all changes in rating, names of new businesses, dissolutions, successions, assignments, receiverships, trusteeships, failures, bankruptcy petitions, current business changes, and accounts placed for collection. In this way the reference book is kept constantly up to date.

Travelers' editions for businesses located in any state or group of states are available in pocket size and flexible covers. They contain the names, business classifications, addresses, and ratings of all dealers, wholesalers, and manufacturers in the specialized lines covered. These editions also include, under each city and town, the population and the names of banks.

Trade Interchange.—Each week a "tracer sheet," representing a national trade interchange in the furniture and allied lines, is mailed to all subscribers. This tracer sheet requests their exeperiences with concerns selected for current investigation because of some unusual circumstance. A creditor may report the manner in which bills are being paid in one of seven different columns on this sheet, depending upon whether the debtor is discounting his bills or paying promptly, slowly, or on C.B.D. (cash before delivery) terms. Eleven other codes are used to describe customers, such as "concern takes discounts in violation of terms," "troublesome account," "first order," or "settles with trade acceptances." A summary of the completed trade investigation (see Figure 18) is mailed to all subscribers who have co-operated by giving their current experiences. The summary is distributed two weeks after the names are initially sent out.

Collection Department.—Like most agencies, Lyon also has a Collection Department to follow up past-due accounts for subscribers. Dun & Bradstreet, Inc., and the National Credit Office, Inc., do not use collection information in their credit reports. Lyon Furniture Mercantile Agency, on the other hand, does use the information that comes through its Collection Department. In fact, a special section of the report is devoted to collection information.

The Jewelers Board of Trade

This is one of the oldest mutual credit services, established in 1873 as the Jewelers Mercantile Agency, Ltd. The present style was adopted in February 1933, when the Jewelers Board of Trade took over the credit-investigating, reporting, collection, and adjustment activities of the National Jewelers Board of Trade and the Manufacturing Jewelers Board of Trade. The enterprise is one of the trade co-operative organizations

in which manufacturers, importers, and wholesalers of jewelry, watches, diamonds, silverware, precious stones, and related articles are members. The executive offices, the collection and adjustment services, and the credit-reporting headquarters are located in Providence, Rhode Island. Branch offices are maintained in New York City, Chicago, and San Francisco

Figure 18 Section of a "Result of Tracer" Sheet Used by Lyon Furniture Mercantile Agency

LYON WEEKLY INTERCHANGE OF TRADE EXPERIENCE

"RESULT" of "TRACER" No. 23

CONDUCTED BY

LYON FURNITURE MERCANTILE AGENCY

Sent only to subscribers who co-operate, and give the ledger and paying record of their customers.

EXPLANATION—[illegible]

[illegible]

Result of Tracer No. 23	ISSUED ONLY TO THOSE WHO ANSWER THE "TRACER"									XLV K.
*Funeral Director exclusively.		[illegible]	1	2	3	5	6	7	Amount Reported Owing	Amount Reported Past Due
ALABAMA										
[illegible] & Co Inc	Birmingham	17	15	2					(2) $560	
[illegible] Furn Co Inc	Birmingham	3	1	2					(2) [illegible]	
ARKANSAS										
[illegible]	Texarkana	3	2	1					(7) 35	
CALIFORNIA										
[illegible] Furn Co	Anaheim	14	14						(3) [illegible]	
[illegible] & Furn	Fresno	8	5	1	2				(3) [illegible]	
[illegible]	Fresno	30	27	2	1				(5) [illegible]	
[illegible], [illegible] & Sons Inc	Long Beach	32	13	11	7	1			(7) 16423	(6) $893
[illegible] Furn Co	Los Angeles	24	15	5	4				(6) 2426	(1) 322
[illegible] Furn Co (Inc)	Los Angeles	9	4	1	3				(6) 2905	(1) 82
[illegible] Inc	Redondo Beach	23	9	3	3	1		[illegible]	(4) 644	
[illegible]	Richmond	4	1	1		1			(3) 1266	
[illegible] Furn Outlet	Santa Cruz	15	1	1	[illegible]	5	1		(7) [illegible]	(5) 1328
CONNECTICUT										
[illegible], Geo E & Son Inc	Bridgeport	23	23	3					(5) 3932	
[illegible] Bros Furn Co	Norwich	3	3							
[illegible] Co The Inc	Stamford	7	6			1			(2) 514	
[illegible] Furn Co The (Inc)	Waterbury	4	2		1			1		
[illegible], Samuel M	Willimantic	3	3	1	1				(3) 1245	(1) 100
DELAWARE										
Miller Bros Co (Inc)	Wilmington	27	24	3					(9) 3729	
FLORIDA										
[illegible] Furn Co	Clearwater	16	7	9					(4) 543	
[illegible], E C Furn Co	Jacksonville	11	5	3	4				(5) 5836	(2) 749
[illegible] Furn Co (Inc)	[illegible]	8	2			2	2	2	(3) 1921	(3) 1921
GEORGIA										
[illegible]	Griffin	11	[illegible]	[illegible]					(2) 954	
MARYLAND										
Charles Furn & Bdg Co	Baltimore	3	1	2					(2) 90	
[illegible] Bros Inc	Baltimore	19	2	2	[illegible]	5			(1) [illegible]	(8) [illegible]
[illegible] & [illegible] Inc	Baltimore	26	11	9	4	1			(4) [illegible]	(1) 9
[illegible] Furn Co (Inc)	Baltimore	12	6	5	1				(3) [illegible]	
[illegible] Furn	Baltimore	5	3	1				1	( ) [illegible]	
[illegible] Furn Inc	Towson	11	11	1					( ) 92	
MASSACHUSETTS										
[illegible] Furn Co (Inc)	Boston	36	[illegible]	[illegible]			1		(58) [illegible]	(7) [illegible]
United Furn Corp of Brockton	Brockton	8	1	1	4		1	1	(5) [illegible]	(2) [illegible]
United Furn Co Inc	[illegible]	8	4	2	2				(4) [illegible]	
[illegible], A G Co (Inc)	Lowell	13	1	[illegible]	[illegible]	2			(3) [illegible]	(5) [illegible]
[illegible] Bros The Inc (Wilson's Corner)	North Andover	15	[illegible]	4	1			1	(3) 525	
[illegible] & [illegible] Inc	Springfield	23	[illegible]	3	2				(12) [illegible]	
MICHIGAN										
[illegible] Furn Co	Lansing	26	[illegible]	6					(5) [illegible]	
[illegible], J W Co (Inc)	Lansing	12	1	1					(1) [illegible]	
[illegible] City Furn Co	[illegible]	[illegible]	[illegible]	3	1				( ) [illegible]	
[illegible], E E Furn Co	Port Huron	7	3	3		1			( ) [illegible]	
[illegible] Furn Co	Saginaw	11	8	2		1			(2) [illegible]	
MINNESOTA										
[illegible] of [illegible] Inc	[illegible]	3	3							
[illegible] Furn Co	[illegible]	3	3						(1) [illegible]	
[illegible] Furn Co	Minneapolis	3		3					(2) [illegible]	
[illegible], Daniel L	St Paul	4	2	1	1				(2) [illegible]	
MISSISSIPPI										
[illegible] Furn Co	Clarksdale	3	2	1						
[illegible] Furn Co	Natchez	[illegible]	[illegible]	[illegible]					( ) 67	

The chief function of the Jewelers Board of Trade is the compilation and recording of essential credit data for the confidential use of members on all concerns, wholesalers, importers, and retailers that manufacture or handle the lines of merchandise in the preceding paragraph. The members contribute quarterly dues to the support of the association.

Credit reports containing the antecedent business history of the officers and owners, financial statements, and ledger facts showing the manner in which trade obligations are met, are prepared on members as well as

on non-members. Investigations from which credit reports are compiled are made by full-time employees and part-time correspondents.

To supplement the credit reports, a rating book, 8½ by 5½ inches and 2 inches thick, containing over twelve hundred pages, is published semi-annually. This rating book contains approximately forty-four thousand names, addresses, business classifications, and credit ratings of concerns active in all branches of the jewelry trade. It is kept up to date by the publication of a four-page weekly "Service Bulletin," which covers the following weekly changes in the jewelry trade:

1. Financial embarrassments classified by name, location, and type of enterprise.
2. Liquidations and changes in controlling interest.
3. Changes in credit ratings.
4. A record of fires, robberies, chattel mortgages, etc.
5. List of individuals whose addresses are wanted.

A "New Name Bulletin" is issued weekly, containing the names of concerns not in the rating book, on which new reports were prepared during the preceding week. Credit reports and names in the rating book carry credit ratings. As pictured on page 108, the rating key is of the same general nature as that of Dun & Bradstreet, Inc. Of the two sections of the key, the letter represents estimated capital, and the numeral indicates credit standing.

The Jewelers Board of Trade carries on other activities, such as assisting in the adjustment of financial problems of honest debtors and the dissemination of statistics relative to the jewelry industry. A research service is maintained to assist merchants in locating sources of supply of specific jewelry merchandise.

Lumberman's Credit Association, Inc.

This agency was started in 1876 by William Clancy. In 1933 the Lumberman's Credit Association, Inc., took over its one specialized competitor, the Lumberman's Blue Book, Inc., which had been operated by the National Lumber Manufacturers Association, a trade association. The association provides a credit information and collection service for the lumber and woodworking industries. All manufacturers, wholesalers, and retailers in the lumber and woodworking trades, numbering approximately eighty-five thousand, are covered. Credit reports contain current trade information, the latest financial statement available, antecedent in-

Figure 19 Rating Key Used by the Jewelers Board of Trade

RATING KEY

In estimates of financial resources, only property, real and personal, subject to execution, or available to creditors, has been included

	Estimated Capital	Credit Standing 1st	2nd	3rd	4th
AA	$1,000,000 and over				
A	750,000 to $1,000 000				
B	500,000 to 750,000				
C	400,000 to 500,000	31	32	33	34
D	300,000 to 400,000				
E	200,000 to 300,000				
F	150,000 to 200,000				
G	100 000 to 150,000				
H	75,000 to 100,000	41	42	43	44
J	50,000 to 75,000				
K	35,000 to 50,000				
L	20,000 to 35,000	51	52	53	54
M	15,000 to 20,000				
N	10,000 to 15,000				
O	6 000 to 10,000	61	62	63	64
P	4,000 to 6,000				
Q	2,000 to 4,000				
R	1,000 to 2,000	71	72	73	74
S	0 to 1,000				

CREDIT RATING ONLY

Where only a Credit Rating is shown, it is impossible to obtain details regarding Capital invested The credit standing is therefore made according to the apparent financial condition investigation indicates. The rating is based entirely upon antecedents credit extended payments, and standing in the community

The absence of a rating following a name suggests that the detailed reports on file at our offices should be consulted.

"75"

Indicates that a loss was sustained either by fire flood hurricane robbery etc but to what extent, if at all, the financial standing will be affected thereby, has not been ascertained or that the business is operated by the estate of a deceased person.

•—In business less than one year.

THE JEWELERS BOARD OF TRADE

formation, the names of officers, directors, partners, or proprietors, an analysis of the financial statement, a summing-up of the credit risk, and a rating. The rating key, which is quite elaborate, is shown on page 109. Headquarters are maintained in Chicago, and one branch is in New York City. A collection service on delinquent accounts is also provided for subscribers.

A rating book is published in May and November of each year, and a supplement to it appears twice each week. Supplements give notice of lawsuits, judgments, fires, creditors' meetings, changes of ownership, removals, deaths, names of new concerns, changes in rating, and other items

Figure 20 Key to Ratings Used by Lumbermen's Credit Association, Inc.

The service number of the office for which this book is issued is ______________

KEY TO RATINGS

Explanation of Symbols Used in This Book and the Supplements Thereto

SEE EXPLANATION OF * RATINGS BELOW

SYMBOLS REPRESENTING ESTIMATED NET WORTH		
Column 1	Column 2	ESTIMATED NET WORTH
5*	4A+	Over $1,000,000
	4A	$750,000 to 1,000,000
	3A+	500,000 to 750,000
4*	3A	300,000 to 500,000
	2A+	200,000 to 300,000
	2A	125,000 to 200,000
3*	1A+	75,000 to 125,000
	1A	50,000 to 75,000
	AB	35,000 to 50,000
2*	B	25,000 to 35,000
	C	15,000 to 25,000
	BC	10,000 to 15,000
	D	5,000 to 10,000
1*	E	3,000 to 5,000
	F	2,000 to 3,000
	EF	1,000 to 2,000
	G	Less than 1,000
L	Net worth indeterminable	

Many changes in ratings are made each day and published in the TWICE-a-week Supplemental Sheets; therefore, to know what our latest rating is you should consult the Supplemental Sheets and the latest Monthly Consolidated Supplement.

1	Prompt pay
2	Medium pay
3	Slow pay
4	Very slow pay
5	Mode of payment indefinite. In justice to those rated "5" we suggest that you obtain our Special Report.
6	We suggest that you obtain our Special Report.
7	Obtain our Special Report.
7½	Because of information just received we recommend that you obtain our Special Report.
8	Not rated because investigation was not completed at time of publication.
9	A new or reorganized concern not in business long enough to establish mode of payment.
10	An operating receivership.
11	Not a credit rating — Reported worthy of confidence in handling orders on a commission basis.
12	Not a credit rating — Degree of worthiness indeterminable in handling orders on a commission basis.

Mode of payment ratings assigned by us are based on our knowledge of the way LUMBER accounts are taken care of. It is a known fact that cement invoices and some others are nearly always discounted or paid promptly, even though LUMBER invoices may be allowed to run past due.

5* 4* 3* 2* 1*	At times certain factors make it impossible to estimate net worth within the limits of a single rating in column 2 of the Key. In column 1 are Star (*) ratings which provide a means of expressing an estimated net worth within the combined limits of several ratings in column 2. For example—a concern rated 3* is estimated to have a net worth somewhere between $35,000 and $125,000.

(Br of)	If a name has printed below it "(Br of)" it means that the business operated in that name is a part (branch) of the business to which "(Br of)" refers, and the credit IS identical.
(Purch dept at)	If a name has printed below it "(Purch dept at)" it means that the principal purchases are made at the office of the name referred to by "(Purch dept at)", and the credit IS identical unless the symbol "‡" is printed after the name.
‡	This symbol just at the end of a name means that the credit is NOT identical with that of the name referred to by "(Purch dept at)".

LUMBERMEN'S CREDIT ASSOCIATION INC.

of current interest. The rating book is a comprehensive directory of concerns in all branches of the lumber and woodworking industries in the United States and the Prairie Provinces of Canada. The volume is 11 by 8¾ inches and 2½ inches thick.

The Produce Reporter Company

The Produce Reporter Company, organized in 1901 to provide specialized credit service for the fresh fruit and vegetables industry, pub-

lishes the *Blue Book* which lists and rates all commercial handlers of such commodities. 'Moral responsibility," or integrity ability "X" ratings, indicates the degree of trading confidence reported, as well as the 'pay" record

Perishable commodities are subject to hazards affecting their quality and condition in growing harvesting, packing, processing, and transportation Markets are subject to considerable price fluctuation. The greater portion of the produce business is done on the telephone, making written contracts or agreements impracticable, so the trading hazard is substantial Buyer, seller, and broker extend credit confidence to each other in every transaction The degree to which each respects his obligation to trade fairly and honestly and to fulfill his agreements in both letter and spirit establishes his "moral responsibility,' or credit reputation Integrity and ability are its chief components Confidential reports are available in written form but are chiefly supplied by telephone

Blue Book ratings are described as 'five point" ratings These are represented by (1) the 'classification or nature of business (with the risk it normally entails), (2) annual volume handled in carlots or carlot equivalents, (3) commodities in which a business specializes (the handling of some of which entails special risks), (4) estimated financial credit worth, and (5) moral responsibility credit rating Paying record is taken into account in the moral responsibility, or 'X," rating

The listings of many businesses contain descriptive facts which report the particulars of their operations, facilities, and services A 'Bank for Drafts,' which is named, is the concern's own bank which can effectively handle perishable food draft collection items.

The *Blue Book* is published semi-annually on April 1 and October 1 Weekly credit-sheet changes, consolidated into a monthly supplement of accumulated changes, keep members informed of all changes of credit significance The *Blue Book* Shippers Directory" lists the names of all shipper-sellers for ready reference to meet the demands of changing supply and demand situations.

A truck broker s section lists and rates, as to dependability, truck brokers now serving the industry, which uses truck transportation on the greater portion of its shipments A weekly "Exchange Bulletin' is a classified advertising medium, containing editorial material on credits and other items of importance to the produce trade, and is supplied to all subscribers The headquarters of the Produce Reporter Company are in Wheaton (suburban Chicago), Illinois, and offices are maintained in New York City and Los Angeles

Figure 21 Key to numerals used in Ratings by the Produce Reporter Co.

When these numerals appear in the "X" Rating Column they are to be interpreted as below. Do not confuse them with the numerals between the "Classification" and the "Commodities", which refer to volume in carlots; or before "M," which indicates financial credit worth.

1 Reported shortage or overdraft not refunded.
2 Reported brokerage due and unpaid.
3 Reported has collected but has apparently failed to remit.
4 Reported slow to pay claim.
6 Reported allowance requested, or deduction made without authority, apparently for insufficient or technical reasons.
7 Reported shipment did not hold out as to weight, or count.
8 Reported neglect furnishing documents proving loading.
10 Reported careless or inexperienced loader.
11 Reported "cancelled" because could buy cheaper.
12 Reported invoice unpaid; claim for allowance reported not fully supported.
13 Reported adjustment requested for alleged failure merchandise fulfill specifications although merchandise seems equal to quality claimed purchased.
14 Reported promise of protection, or allowance, not fulfilled.
15 Reported failed to ship when market advanced after order was accepted.
16 Reported shipment on "acceptance final" contract did not meet its specific warranties.
19 Reported ordered goods shipped which were partly sold—without so advising seller.
24 Reported weak on adjustments.
26 Reported has made partial or installment remittance on a due or past due account.
27 Reported slow pay.
28 Reported delay in accounting and/or remitting on consigned merchandise.
29 Reported slowness in payment of draft, or drafts.
31 Reported has shipping affiliation or affiliations.
32 Reported has brokerage affiliation or affiliations.
33 Reported "Kicker" or "Refuser."
34 Reported has delayed payment while allowing car or cars to remain unloaded.
35 Reported has receiving, jobbing or brokerage affiliation or affiliations.
36 Reported overquotes the market to get consignments.
37 Reported have tendered, or issued, one or more post dated checks.
38 Reported check, or accepted draft, returned unpaid.
39 Reported is representative of one or more "Sales Agencies" or "Distributors," and as also doing business under their names.
40 Reported are affiliated with one or more firms or individuals in same line of business.
41 Reported complaining of quality of stock, or shortage, and makes or forces reduction of draft.
42 Reported made claim "Unsuitable shipping condition" on car purchased FOB which met contract grade at shipping point per government inspection certificate.
45 Reported has retail affiliation or affiliations.
46 Reported check, accepted draft, or note protested or returned *for lack of sufficient funds.*
47 Reported "cash" terms appear desirable.
52 Reported as apparently unjustifiably rejecting.
53 Reported refusing shipment or cancelling order on market decline.
54 Reported cancelled order after shipment was made.
58 Reported appear to be buying beyond their needs.
59 Reported soliciting consignments without regard to shippers' interests.
60 Reported trade standing not yet sufficiently established to write a definite rating (usually new firm).
61 Reported exacting under adverse market conditions.
62 Late financial information makes it difficult to write a definite rating, although moral standing appears *to be reflected by the rating* assigned.
63 Reported has violated contract.
64 Reported using Trading Membership Seal and are not entitled to do so.
65 Financial statement received.
66 Reported can get no reply to letters.
67 Fails to comply with request for financial statement.
68 Information as applied to financial condition as well as reports from the trade confusing, making it impossible to write an unqualified rating.
69 Reported previous report should be revised to read—
70 Change *Phone Number to* read—
71 Following is change in, or addition to, Descriptive Facts—
72 Following descriptive facts supplement present Blue Book listing—
75 Under investigation, result will be reported later.
76 Under reinvestigation, result will be reported later.
79 Reported VERY IMPORTANT, only disclosed in special mail report.
80 Reported trading confidence in this branch is different from that of Headquarters.
81 Reported indicted.
82 Reported indictment closed ———.
83 Confidential report presents detailed facts of contingent situations. Rating reflects current trade reports.
84 Reported discharge in bankruptcy approved.
85 If interested, a special report will be furnished upon request.
86 Difficult to write an unqualified rating. If interested a detailed special report will be furnished upon request.
87 Reported recently commenced business.
88 Reported out of business.
89 *Discontinued here.*
90 Reported asking general extension.
91 Reported granted general extension.
92 Reported granted temporary extension by one or more creditors.
93 Reported sued.
94 Reported sold out, or selling out.
95 *Reported asking temporary extension of one or more.*
96 Reported partnership dissolved.
97 Reported chattel mortgage given.
98 Reported real estate mortgage given.
99 Succeeded by
100 Reported filed petition *for* reorganization.
101 Reported left town.
102 Reported no property within reach of the law.
103 Reported deceased.
104 Reported offering to compromise.
105 Reported damaged by fire.
106 Reported voluntary petition in bankruptcy filed.
107 Reported involuntary petition in bankruptcy filed.
108 Reported liquidating.
109 Reported business is in hands of creditors.
110 Reported insolvent.
111 Reported compromised with creditors.
112 Reported petition in bankruptcy filed.
113 Reported suspended operations; obligations reported not fully liquidated.
114 Reported assigned.
115 Reported receiver appointed.
116 Reported receiver applied for.
117 Reported attachment filed.
118 Reported using Membership Seal; not entitled to it.
119 Reported judgment taken against them.
120 Reported closed by execution.
121 Reported involved.
122 Reported have held meeting of creditors.
123 Reported called meeting of creditors.
124 Rating suspended pending a reinvestigation.
125 Reported violated Produce Agency Act.
127 Reported Federal Trade Commission complaint alleges violation Robinson-Patman Act. Hearing date.
128 Refused to submit a financial statement.
129 Reported corporation dissolved.
130 Claim based on these allegations has been placed in our hands, amounting to $.........
131 A claim has been placed in our hands for alleged deficit on consigned cars alleged due and unpaid amounting to $.........
132 Rating withdrawn.
133 Trading membership withdrawn.
134 A report or claim has been submitted alleging failure *to fulfill contract.*
135 Subscribers will please report their experiences, favorable or unfavorable.
136 Combination of parties formerly rated differently.
137 A claim has been placed in our hands for alleged unjustifiable or unauthorized deduction from invoice amounting to $.........
138 Reported refuses to arbitrate.
139 A claim has been placed in our hands for alleged loss caused by alleged unjustified rejection.
140 Claim placed with us for collection amounting to $......... has been settled.
141 A claim has been placed in our hands for brokerage alleged due and unpaid amounting to $.........
142 A claim against him or them has been placed in our hands *for* alleged *past due* balance amounting to $.........
144 Reported no definite estimate as to financial worth.
145 A claim against him or them has been placed in our hands amounting to $.........
146 Reported that one or more of parties interested were associated with a business which experienced financial difficulties prior to entering present business—rating reflects current trade reports.
147 Have conflicting reports—some indicate is better than rated.
148 Have conflicting reports—rating indicates reported general experience.
149 Reported change in management or policy. Present rating covers reported present policy.
152 Reported P. A. C. A. license suspended for ....
153 Reported P. A. C. A. license revoked ....
158 Reported have made remittance of funds not reported in original accounting.
159 Reported crop mortgage filed.
160 Reported conditional sales agreement filed.
161 Reported chattel mortgage released.
162 Reported real estate mortgage released.

LATEST RATINGS
Are Contained in the Weekly Credit Sheets and Monthly Supplements
USE THEM

Figure 22 Explanation of How to Read Ratings in the *Blue Book* of the Produce Reporter Co

How to Read Ratings

THERE ARE FIVE DISTINCT POINTS OF INFORMATION IN EACH RATING AS FOLLOWS:

Under each name is shown (1) classification of business, (2) number of carlots handled, or trucklot tonnage in terms of carlots (3) principal commodities or specialties handled in order of importance (4) estimated financial credit worth (5) "X's" reporting general credit standing based on reported integrity ability and pay record. (The omission of an "M" rating or any other portion of a rating, indicates we are without current information to make such a report.)

SAMPLE RATINGS

Skinner, Will	R	C	J	150	P	O	A	Cab	25M	X
True, John	G	B	(TL)	A	Pc	Bs			5M	XX
Hustler, A.	B	1000	Let	Cel	Gs	Cants	VF		—M	XXX

(1) Classification of Business

B	Selling Broker
BuyB	Buying Broker
C	Commission Merchant
Dhd	Dehydrater
Evap	Evaporator
Exp	Exporter
FP	Fruit packer
G	Grower
Gm	General merchant
Imp	Importer
J	Jobber
(LCL)	Handles the following in less than carlot quantities
LP	Loading Point
Mfr	Manufacturer
Pkr	Packer
R	Receiver (from distant shippers)
Ret.	Retail
Rg	Retail grocer
S	Shipper (to distant receivers)
SL	Handles the following as a "Side Line"
Stor	Storage
Tr	Trucker
(TL)	Trucklots
Wg	Wholesale grocer

(3) Specialties

A	Apples
Ap	Apricots
Ar	Artichokes
Asp	Asparagus
Av	Avocados
Ban	Bananas
Bb	Blackberries
Bc	Broccoli
Bn	Dried Beans
Bl	Blueberries
Bs	Green Beans
Boy	Boysenberries
Br	Brussels Sprouts
Be	Berries
Bt	Beets
Cab	Cabbage
Cal	Calif. Fruit
Cants	Cantaloupe
Cas	Casabas
Cel	Celery
Celcab	Celery Cabbage
Cf	Canned Fruit
Cg	Canned Goods
Ch	Cherries
Cit.	Citrus
Cu	Cucumbers
Cl.	Cauliflower
Co.	Cocoanuts
Cr	Cranberries
Ct	Carrots
Cu.	Currants
Cy	Chicory
D	Dried Fruit
Db	Dewberries
Dec	Deciduous Fruit
Dhd	Dehydrated
En	Endive
Ep	Eggplant
Es	Escarole
F	Fruit (general line)
Fj	Fruit Juice
Gar	Garlic
Gb	Gooseberries
Gc	Green Corn
Gf	Grapefruit
Gn.	Greens
Gr	Grain
Gs	Grapes
Hb	Huckleberries
Hr	Horseradish
Hy	Honey
Hyb	Honeyballs
Hyd	Honeydews
J	Juice
K	Kraut
Kl	Kale
L	Lemons
Lb	Loganberries
Lbe	Dried Lima Beans
Lba	Green Lima Beans
Let	Lettuce
Ls	Limes
M	Mushrooms
Ms	Watermelons
Mix	Mixed Vegetables
Mt	Mistletoe
N	Nuts
Nec	Nectarines
O	Onions
Ok	Okra
Ol	Olives
Or	Oranges
P	Potatoes
Pa	Pineapples
Par	Parsnips
Pe	Peaches
Pd	Produce (general line)
Ps	Peas
Pep	Peppermint
Per	Persimmons
Pl	Plums
Pom	Pomegranates
Pp	Peppers
Pr	Pears
Ps	Prunes
Qs	Quinces
Rb	Rhubarb
Rd	Radishes
Rp	Raspberries
Rut	Rutabagas
Seedp	Seed Potatoes
Sh.	Shallots
Sou	Southern vegetables
Sp	Sweet Potatoes
Spin	Spinach
Sq	Squash
St	Strawberries
Sug	Sugar
Sup	Grocery Supplies
Tg	Tangerines
Ts	Turnips
Tom	Tomatoes
V	Vegetables
Watermelons	Rated as Ms
Xt	Christmas Trees
Yb	Youngberries

(4) Estimated Financial Worth

—M	Less than 1M
1M	$1,000
10M	$10,000
100M	$100,000
1000M	$1,000,000 and over

(5) Reported General Credit Standing, Integrity Ability and Pay Record

XXXX	Excellent	As explained on Page 13
XXX	Good	
XX	Fair	
X	Doubtful	
X—	Poor	

§ in front of a name indicates that such concerns ship, sell or buy thru others; or follow other restricted selling or buying program.

† in front of a town name indicates county seat.

‡ in front of a firm name indicates a "divided responsibility"—i. e., that one or more of the parties interested are also responsible for the debts of another business.

TAKE NOTICE: NUMERALS ARE USED IN THREE PLACES:

1. When they precede specialties they show the carlot, or trucklot, volume.
2. When they precede "M" they indicate the amount of estimated financial credit worth.
3. When they appear in the "X" column, or follow X's, refer to the key on preceding page.

PLEASE NOTICE THE FOLLOWING DEFINITIONS—THEY WILL ENABLE YOU TO BETTER UNDERSTAND THE CLASSIFICATIONS.

SHIPPERS "S": Are located at shipping or intermediate points and have for sale in their own names merchandise which they have grown and packed, or which they have purchased from loaders or shippers, or which they may sell for the account of growers, loaders or shippers.

RECEIVERS "R": Firms at destination points who buy and receive carlots or full trucklots and who resell same intact or in large jobbing lots. While they may sell and "ship" to their consuming area trade, such portion of their operations is not "shipping" within the meaning of the foregoing "Shippers" classification.

COMMISSION MERCHANTS "C": Act as agents for the sale of merchandise on commission.

BROKERS "B": Are those who act as agents for shippers. Brokers are classified as "Receivers" also, only when the merchandise which they endeavor to sell "off track" is their own. Buying Brokers act as purchasing agents for distant Buyers.

JOBBERS "J": Are those who sell in small lots principally to retailers, and who purchase their supplies in carlots or less from Receivers on their home market.

TRADING MEMBER

THE NAMES OF TRADING MEMBERS ARE PRINTED IN BOLDFACED TYPE. IT IS AN HONOR SERVICE. FOR ELIGIBILITY REQUIREMENTS SEE PAGE 9

National Association of Credit Management

The National Association of Credit Management is a co-operative professional and service association of the mercantile and financial credit managers of the country. Organized in 1896, the National Association has grown steadily in influence and in size. It undertakes a wide variety of cooperative activities for its members and brings them together in an annual convention. It publishes yearly a credit manual on commercial laws, the *Credit Management Handbook*, and an official monthly magazine, *Credit and Financial Management*. Its fraud prevention department investigates and prosecutes perpetrators of commercial fraud. Through the National Institute of Credit, courses in credit, banking, business law, and merchandising are given in large cities.

Through an affiliated organization, the Credit Research Foundation, Inc., it makes periodic national summaries of accounts receivable and carries on research projects in other areas of interest to credit management. Recent reports have included a review and an analysis of data processing for the credit department, the formation and development of a credit department, and the financing of industrial equipment leases. The research and educational affiliate of the National Association of Credit Management also conducts three-year graduate schools (for two weeks a year) at Stanford University and Dartmouth College, sponsors courses for credit executives at thirty-six other colleges and universities, and conducts two correspondence courses. The National Association also sponsors trade group meetings for the discussion of specific cases of credit. Along with these strictly co-operative endeavors, the association has developed a modified credit-reporting service and a collection and adjustment service.

Ledger Interchange Reports.—While specialized agency services have been developing and expanding, a second type of credit service under the sponsorship of the National Association of Credit Management has been made available. This service is concerned solely with making trade investigations. Reports contain only actual facts regarding the relationship between buyer and seller. No opinions, summaries, or ratings are provided.

"Ledger interchange," as this type of reporting has come to be called, is the outgrowth of the recommendation, or "letter of reference," which early in the nineteenth century the new buyer brought with him from the West when he came to the Eastern market. The letter explained the reputation of the prospective buyer among his business neighbors. Since this information was at times misleading, the need arose for an independ-

ent and impartial credit service.[2] Out of this situation grew the common practice of one creditor giving information to another regarding the paying record of a mutual account.

Later, organizations known as "reference bureaus," carrying in their files the names of creditors of a given customer, were established. When a member desired credit information, he obtained the names of other creditors of the account from his reference bureau and communicated with them direct for their experience. Next came the Credit Interchange bureaus, which not only carried a record of the names of creditors of an account but also solicited credit information and compiled trade reports for their members.

The first Credit Interchange bureaus operated only in a local market. In 1912 a central bureau was organized in St. Louis to enable the local bureaus to exchange information. In 1919 the National Association of Credit Management took over the central bureau at St. Louis and since that time has been the sponsor of the ledger interchange service. Fifty-nine bureaus covering most of the major and minor markets now constitute the National Credit Interchange System. All of the fifty-nine bureaus are owned, controlled and operated by local members. In the majority of cases operations are carried on under the supervision of the local Credit Men's Association.

Two methods are used in the preparation of reports. In 10 per cent of the bureaus, primarily in major metropolitan areas such as Chicago, Los Angeles and New York, the procedure is as follows. Upon joining a local Credit Interchange Bureau, a business concern files a complete list of its active accounts including C.O.D. and cash-in-advance customers, and those who are extended regular credit terms. This list is then broken down by the bureau and recorded under the name of each customer, the new member's interest being shown by a code number placed on each customer's card. Thus, when an inquiry is received on the Clark Grocery Company, for example, the card on that name will show the code numbers of all bureau members selling the account. Thereupon, these sellers may all be canvassed for their current ledger experiences.

When a member asks for information on a customer, the files of his local bureau disclose the identity of other creditors in that market, and they are canvassed for information. When completed, copies of the final report are placed in bureaus in all markets in which the customer is

[2] For a history of the evolution from letters of reference to credit reporting see Roy A. Foulke, *The Sinews of American Commerce* (New York: Dun & Bradstreet, Inc., 1941), pp. 358–74.

buying merchandise, as well as the coded identity of other markets which had previously reported interest. All known sources are then canvassed for their information. The responsibility for compiling the report rests with the bureau in whose area the subject is located, but all information regardless of its point of origin is sent to the zone bureau for compilation of the final report.

A second method, more recently installed, is now practiced by 90 per cent of the Credit Interchange bureaus. The bureau sends all members a daily "Inquiry Sheet" listing all in-zone customer accounts by name and address. Thus, the files of the local bureau on all in-zone subjects constitute a record of all local creditors who participate in the interchange and who sell a customer, as well as of other markets in which purchases are being made. When a clearance is made, members of all bureaus selling the customer under investigation are canvassed for information without regard to industry or location.

An inquiry from a member is answered, first, with a copy of any report on file. If that report is less than 120 days old, the inquiry is considered answered, unless the member has reason to believe there has been a very recent change in the subject's payment record. If more than 120 days old, the report bears a stamp reading "Note date—we are revising." In a few days the member begins to receive a series of supplemental current reports, as clearances are completed first in the local market and then in outside markets. When all markets are heard from, which might take several weeks, the member receives a final report which combines all the information in the earlier reports. The final report thus becomes an up-to-date review of the buying and paying habits of a customer with all known creditors who participated in the interchange.

The report is divided into nine vertical columns. Each horizontal line summarizes under these nine headings the actual credit experiences of a particular concern with the account in question:

1. Business classification
2. How long sold
3. Date of last sale
4. Highest recent credit
5. Amount owing
6. Amount past due
7. Terms of sale
8. Manner of payment
9. Comments

Collection and Adjustment.—The Collection Department of the Na-

tional Association offers several types of service to its mercantile members in collecting past-due accounts throughout the country. Service charges vary with the difficulties involved in handling specific accounts. The Adjustment Bureau takes up where the Collection Department leaves off: it investigates accounts that are financially involved and assists in working out extension agreements, compromise settlements, and friendly liquidations. In the case of receiverships and bankruptcies, the Adjustment Bureau uses its efforts to obtain as receiver or trustee an individual from within its own group who would best serve the interests of the creditors.

AGENCIES REPORTING PRIMARILY ON INDIVIDUALS

The problems involved in investigating and compiling credit reports upon individuals applying for bank loans, business positions, insurance, and instalment credit are far different from those involved in investigating and preparing credit reports upon active commercial and industrial business enterprises. Local sources of information are generally adequate. Moreover, credit reporters who handle this type of investigation generally do not need the knowledge that can be obtained only by years of experience in the oustanding peculiarities of industries, in the interpretation of intricate financial statements, in the delicate balancing of favorable and unfavorable factors in the affairs of manufacturers, importers, exporters, motor carriers, finance companies, wholesalers, and retailers.

A credit report on an individual is generally sent to only one subscriber. Often no further inquiry is received after an investigation has been made and a credit report prepared upon an individual. If, however, a second inquiry is received within two or three months, another investigation must be made to verify the fact that the subject is still employed, that he lives at the same address, that he has not met with an accident, and that he is not disabled or ill. In contrast to agencies covering mercantile enterprises, specialized agencies in this field must therefore be geared to earn a profit on single inquiries. This type of service is largely covered by two organizations—the Hooper Holmes Bureau, Inc., and the Retail Credit Company.

The Hooper-Holmes Bureau, Inc.

The headquarters of the Hooper Holmes Bureau, Inc., are maintained in Morristown, New Jersey. Branch offices are located in 125 important cities in the United States and the Dominion of Canada. The business was established in 1899 under the name of the Hooper Holmes Information

Bureau. In its early days its sole purpose was to act as an information clearing house for accident and health insurance companies. This particular operation, now known as the Casualty Index, today furnishes protective information to life, accident, and health insurance companies.

In 1912 credit reports were first issued on individuals. This coverage of individuals subsequently developed into the principal function of the business. Probably 75 to 80 per cent of all reports are prepared on behalf of insurance companies desiring credit, moral hazard, and underwriting information on individuals who are taking out or increasing some form of insurance. The balance of the reports are prepared largely on behalf of commercial banks and trust companies; specialized finance companies which finance the instalment sales of automobiles, refrigerators, washing machines, and similar products; mail order houses; concerns engaged principally in selling merchandise on the deferred-payment plan; and personnel reports for companies in practically every industry. A newly organized Market Research Department handles consumer survey work.

The wide variety of specialized reports available for all types of business is indicated by the following: Reports are prepared by "inspectors" employed on a base salary in the larger cities. At less important points inspectors are reimbursed at so much per report. Reports on individuals in country towns and hamlets off the beaten path are generally handled by correspondents. In this field of credit activity, reports carry no rating. Naturally no rating books are published.

Most of the credit reports prepared by the Hooper-Holmes Bureau, Inc., as well as those of the Retail Credit Company described below, are known as "questionnaire" reports, in contrast to the "narrative" reports of mercantile agencies. The questionnaire report is invariably confined to one sheet of paper. The front carries a series of questions to be answered by the investigator. The Hooper-Holmes report on page 118, for example, shows seventeen main questions, with space for the answers to the right, separated by horizontal lines.

Supplemental facts are added at the bottom of the page and on the reverse side. In this instance, the information is arranged under three headings—"Finances," "Occupation," and "Standing"—which round out the data gathered by the specific questions in the first part of the report.

Retail Credit Company

The only other national agency concentrating in this field of reporting on consumers is the Retail Credit Company. Headquarters of this enter-

Figure 23 Copy of a Hooper Holmes Bureau, Inc., Individual Credit Report

CREDIT REPORT—INDIVIDUAL

THE HOOPER HOLMES BUREAU INC
CONFIDENTIAL

CAUTION TO CUSTOMER The contents of this report are to be held in Strict Confidence in accordance with our agreement, and not revealed to the person reported upon or to any one else.

Name	DOE J C (CORRECT DOE JOHN C)
Res. Add.	Smithtown Mass 123 Boston Street
Occ. & Empl.	Auto mechanic Smithtown Chevrolet Inc
Bus. Add.	Main St Smithtown Mass
Age	32
File No.	E-13542
Bank or Trade References	Smithtown National Bank
Date etc.	8 5 8
Co. No.	9753

	Question	Answer
1 IDENTITY	A. How many years have you or EACH of your informants known him?	A. 4 5 5 8 years
	B. If known less than one year what was former address?	B
	C. What is his age? His racial descent? Greek, Negro, Italian etc.	C. Age 32 Race White
	D. What is marital status? E. How many dependents has he?	D. Married E. 3
2 FINANCES	A. Estimate total Net Worth. Home, savings, business, stocks, etc.	A. $7 500
	B. Approximate value of home? if owner	B. $15 000
	C. Approximate monthly rental? if tenant	C. $ —
	D. Estimate EARNED yearly income from work or business.	D. $5 200
	E. Give approximate income of other wage earners in family if any	E. $
	F. Is he in financial difficulties or has he had reverses?	F. no (If YES explain in Remarks)
	G. Is there any criticism of his or family bill paying habits?	G. no (If YES explain in Remarks)
3 OCCUPATION	A. What is his occupation?	A. Auto mechanic
	B. If employed, what is the name of his employer?	B. Smithtown Chevrolet Inc
	C. How long so employed? If less than one year give former employer	C. 5 years
	D. What is the nature of the business?	D. Auto sales & service
4 STANDING	A. Is he criticized for any of the following Domestic troubles? Drug or Liquor habit Illegal activities? Unlawful business?	A. No
	B. Is there any criticism of his character morals or associates?	B. No

5. Head paragraphs A, B, C. Type SPECIAL FEATURE if any and name paragraph under which details are given.
A. FINANCES Cover credit reputation amplify any YES answers given in #2 above
B. OCCUPATION Employer type business time employed-former job if less than year degree of success if own business.
C. STANDING With whom does he live how long here moral reputation social standing environment Describe home neighborhood

CONTACTS Information in this report was obtained from nearby neighbor who has known him for four years a local banker known for past five years employer known 5 years and a local merchant known 8 years

FINANCES The subject pays his bills promptly as agreed and bears a good credit reputation Maintains a satisfactory low three to medium three figure checking account at the Smithtown National Bank and makes his home mortgage payments promptly at this same bank His salary is $5 200 per year with no other income Worth of $7 500 is based on personals auto cash on hand and in bank and equity in home

OCCUPATION For the past five years he has been employed as an auto mechanic first grade at the Smithtown Chevrolet Inc large successfully operated Chevrolet Sales and Service Agency Smithtown Mass He has a good employment record and is well regarded by his employer

STANDING The subject is 32 years of age married and living with his wife and two young children 5 and 8 years of age at 123 Boston Street Smithtown Mass Has resided here with his family for past 4 years Home is located in a good middle class section with environment being favorable The subject lives congenially with wife and children conducts himself properly does not drink to excess and is well regarded We learn of no criticism of his reputation

JBC BOSTON OFFICE

prise are maintained in Atlanta, Georgia, and branch offices are located in 250 other cities in the United States and the Dominion of Canada. In all, over fifty-five hundred full-time investigators are stationed in some thirteen hundred cities in the United States, Canada, and Mexico. In addition, Retailers Commercial Agency with offices in sixty cities and the Credit Bureau of Montreal with three offices in Canada are subsidiaries of this organization.

The business was established in 1899 in Atlanta to provide an individual checking service for local retail merchants. Inquiries, however, began to be received from life insurance companies in 1902 for information about individuals, and supplying this information, as in the case of the Hooper-Holmes Bureau, Inc., gradually became the primary activity of the business. Later, fire and casualty insurance companies and surety companies began using these reports for underwriting and claim purposes.

Today the company also provides a wide range of personnel-selection services for industry. Reports are used in passing upon the credit of individuals and small firms, in underwriting individuals for various types of insurance and bonds, in judging insurance claims, and in selecting new agents, dealers, salesmen, and representatives.

Like its principal competitor, the Retail Credit Company has a large variety of report forms. These reports vary considerably in order to provide information pertinent to the particular type of transaction under consideration or of individual involved. The reports, all of the question-and-answer type, may be divided into six general groups:

1. Character and credit information about individuals other than farmers.

2. Character and credit information on farmers. These reports state the size of the subject's farm, whether owned or rented, the type of farm (truck, daily, mixed, or specialized crops), and whether the farm is operated profitably.

3. Character and credit information on proprietorships and firms. These reports cover the character, ability, finances, and antecedents of principals as well as the credit record of the concern.

4. Delinquent purchase reports, presenting information by which to judge the collectibility of past-due accounts.

5. Personal history reports, presenting information on individuals being considered for employment.

6. Special investigations on unusual situations or transactions beyond the scope of the regular reports. Specialized reports are also available for determining the payment plans of slow payers. More recently the com-

pany has offered a service whereby the credit cards of delinquent holders could be picked up.

Investigators obtain their information for reports by interviewing logical sources of information, such as employers, banks, creditors, and

Figure 24 Copy of a Retail Credit Company Character Credit Report

RETAIL CREDIT COMPANY
CHARACTER CREDIT REPORT
(INDIVIDUAL)

Founded 1899

CONFIDENTIAL

R—— OFFICE

Acct. No.

REPORT FROM F——, N Y (If not city or heading) — Present address (State whether former addr., etc.)

R——, I—— R , Dr
F——, N Y , - 810 - 12th Ave , No
Dentist

File No. Age 52

Transaction. Dental Equipment
Amount $ $180 00
Mo. Notes $ $15 00

IDENTITY	1. Time known (years) by you and each informant?	1. You? 6 Informants? 2, 4, 5, 3 yrs
	2. Are name and address correct as given above?	2. Yes
	3. About what is his age? (If around 21 verify if possible.)	3. 52
	4. Is he married? Number dependents including wife?	4. Yes Number of Dependents? 1
	5. What is his racial descent?	5. Anglo-Saxon
EMPLOYMENT	6. By whom is he employed? (Give name of firm.)	6. Self
	7. What is nature of business? (State the kind of trade or industry.)	7. Dentist
	8. What position does he hold?	8. -
	9. How long in present employment? (If short time or changes frequently explain.)	9. 28 yrs
	10. Do current conditions indicate good prospects for continued permanent employment on present job? If not explain.)	10. No See remarks
FINANCES	11. About what would you estimate his Net worth?	11. 6,000
	12. Of what does worth consist principally? (Real estate, cash, stocks, bonds, etc.)	12. Home, household goods, equipment
	13. Does he own or is he buying his home?	13. Yes
	14. About what is his ANNUAL income from employment? (If a professional man or owns business estimate net income from such.)	14. $ 3,000
	15. About what ADDED income from investments, rentals, pensions, disability etc.? (If any show amount and source.)	15. $ None Source:
	16. If married, does wife follow gainful occupation? (Wife's income.)	16. No Wife's Income $
CHARACTER	17. Is he steady, progressive, and does he work full time? (If irregularly employed show number days works weekly.)	17. No
	18. Does he live within his income?	18. No
	19. Any criticism of reputation as to honesty or fair dealings? (If so, what?)	19. Yes
	20. Any illegal activities, or domestic troubles?	20. No
	21. Has he or any member of his family had any illness (physical or mental) that might affect ability to pay? (If so, explain.)	21. No
	22. Any failures, bankruptcies, mortgage foreclosures, suits, judgments or garnishments against him? (If so state which. Give details.)	22. No
	23. Do you recommend doing business with applicant on a credit basis?	23. No

24. BUSINESS Comment on past and present business connections, success and prospects for future. Amplify any unusual or unfavorable information which might affect his ability to pay promptly.

25. PROPERTY Show all property owned (both real estate and personal) and estimated value.

26. CREDIT RECORD (Sources: Creditors such as Hardware, General Mdse., Department, Grocery, Men's Store, Bldg. Supply, Banks, etc.) Show how regarded as credit risk.

Kind of Business	How Long Selling	Still Selling	Highest Credit Extended	How Much Owing	Is It Past Due	Paying record on Specify 30, 60, 90 days, etc. (Is this in accordance with terms?) If Contract Acct., so state.
Furniture	2 yrs	No	$215 00	$75 00	Yes	90 days
Clothing	2 yrs	No	75 00	20 00	Yes	Unsatisfactory
Grocer	5 yrs	No	30 00	16 00	Yes	60 days

CREDIT RECORD Dr I R —— does not bear a good credit reputation An oil company has had to stop credit because of slow pay The two local dental supply houses require cash Local bank made small loan one year ago which he paid as agreed

BUSINESS, He has been practicing dentistry here since his graduation from dental college 28 years ago His practice developed well but has declined steadily in the past three years due to his habits Patients have noticed liquor on his breath during office hours which has caused considerable adverse comment He is not in good financial condition as his income is not sufficient to cover his household and office expenses

PROPERTY: Applicant is buying his home and has an equity of about $3,000 at the present time He owns furniture and personal property worth about $2,000 He still owes a small amount on some of his office equipment

RETAIL CREDIT COMPANY Signature of person making report CHARACTER CREDIT REPORT—INDIVIDUAL

associates. Reports on individuals who live in small and somewhat isolated communities are made by part-time investigators. All unfavorable information is confirmed, wherever possible, through records.

On page 120 is a typical character credit report on a dentist who is purchasing dental equipment for $180 on an instalment plan, payable at $15 per month. The principal information is given at the right-hand side of the report in answer to twenty-three questions covering the major headings of identity, employment, finances, character. Following these questions and answers, a narrative section covers the credit record of the individual, based on a trade investigation, business history, prospects, and property owned.

In this particular report, the trade investigation through three creditors indicates that the individual is slow or unsatisfactory in payments although he has paid off, as agreed, a small bank loan. His financial difficulties are explained in the paragraph on business by the fact that his practice has declined steadily for three years, due to habits that are unacceptable to patients. The paragraph on property indicates that he has a small equity in a house that he is purchasing and still owes a small amount on some office equipment; otherwise, his wealth consists only of furniture and personal property.

Inquiries are answered only with current reports. Supplementary file information is used to strengthen the background of reports, but a fundamental principle of the service is to report the status of an individual or a firm as of the day the report is edited.

AGENCIES THAT MAKE SPECIAL INVESTIGATIONS

The two groups of agencies that we have already considered cover certain definite fields: the mercantile agencies primarily investigate and prepare credit reports upon concerns, whether they are proprietorships, co-partnerships, corporations, common law trusts, or associations operating actual commercial or industrial business enterprises; while the specialized "personnel" agencies investigate and prepare credit reports on the moral and financial responsibilities of individuals who are taking out some kind of insurance, seeking credit from a banking institution or for the purchase of some product on the deferred payment plan, seeking employment, or owing on past-due accounts.

A third group of agencies is engaged in the preparation of credit reports on both individuals and all types of concern, including actual commercial and industrial business enterprises, law firms, accounting firms, investment

counselors, investment bankers, brokers, and the thousands of individuals who make a living legitimately and illegitimately on the fringe of the financial world The reports prepared by these agencies are of an intimate nature and are often used by subscribers to the first two groups Three well known agencies handle work of this character Proudfoot's Commercial Agency, Inc, and Bishop's Service, Inc, both located in New York City, and Hill's Reports, Inc, in Chicago

Proudfoot s Commercial Agency Inc

This enterprise was organized in 1900 by Louis A Proudfoot, a New York attorney Proudfoot knew so much about people of prominence and notoriety that other lawyers sought his opinion about more or less well known characters In 1900 he supplemented his personal knowledge by starting a card index of all judgments and bankruptcies in New York County and of clippings from New York newspapers regarding the questionable antecedents and activities of individuals whose names found their way into print This service was initially developed in behalf of other lawyers

Special comprehensive and confidential reports in the form of letters are now prepared on individuals, partnerships, corporations, or associations in almost every line of business or service in the United States for the purpose of aiding clients in forming an opinion as to the desirability of the extension of credit or other courtesies An inquiry might be about a business enterprise, the responsibility of an individual who is seeking employment or membership in a stock exchange or a country club, the history and reputation of an accountant in behalf of a corporation that is changing its auditors or of a banker who has been offered the accountant's audit by one of his borrowing accounts, it might be about an individual who is being considered as a potential official or director of a corporation or a Wall Street investment dealer in behalf of a concern whose securities are traded in the market While the scope of Proudfoot s service is extremely wide, it is flexible and lends itself to confidential inquiries with discretion

Reports on individuals, no matter why the inquiry is made, cover age, place of birth, home life, extent of education, business activity, and dates of former business connections and club memberships Suits, judgments, bankruptcies, and criminal record (if found) are recorded Then follow comments on past record, financial responsibility, and method of paying

bills, bank and other credit information, integrity, moral standing, and business reputation. Similar comprehensive information is obtained on partnerships, corporations, associations, and professional firms.

The index of suits, judgments, and bankruptcies now consists of millions of 3-by-5-inch cards. Reports are rendered to concerns and firms in all lines of business and service activity and to many commercial banks, trust companies, investment bankers, security dealers, and stock brokers, as an agent under an agreement that the information requested is for the use of the client and shall be strictly confidential.

Since these reports are made for the client's specific need, it is essential, in placing such an order, to disclose the full reason for the investigation, so that the report may be pointed in the right direction and supply the answers to the particular problem.

Bishop's Service, Inc.

This agency was established in 1897 in New York City. Operations are confined largely to investigating and preparing credit reports upon individuals, firms, corporations, associations, and syndicates with headquarters in the financial district of New York City. No branches have ever been operated.

The business initially was organized to investigate the moral and financial background of individuals and concerns in the banking, investment, and brokerage fields. Reports were gradually developed to contain antecedent information, opinions of outside authorities, and investigations with banks of accounts. Investigations are made of individuals and concerns of prominence and high esteem, as well as of those of questionable integrity.

Reports of Proudfoot's Commercial Agency, Inc., and Bishop's Service, Inc., are prepared in letter form and contain neither ratings nor summaries. The subscriber is free to draw his own conclusions after carefully perusing the detailed information. Probably 75 per cent of the subscribers to these services are commercial banks, trust companies, investment bankers, brokers, and others who make their offices in the financial district of New York City. The remaining 25 per cent are commercial and industrial houses, lawyers, and accountants, a moderate percentage of whom are located in other cities.

As in the case of most mercantile agencies, service is rendered on a yearly fee basis. This fee entitles the subscriber to make a certain number

of inquiries each year In the particular case of Bishop's Service, Inc., the service fee, however, also entitles the subscriber to the unlimited use of information already in the files

Hill's Reports Inc

This business was organized in 1895 for the primary purpose of furnishing reports on individuals to members of the Chicago Board of Trade La Salle Street in Chicago is the largest finance and money market in the country outside of New York City, and in view of its importance there naturally gravitate to it individuals of widely different moral and financial responsibility Hill's keeps records files and clippings and prepares reports on individuals and concerns for the use of those active in the Chicago financial district, just as Proudfoot's and Bishop's do in New York City

This type of reporting has continued to be an important part of the service During recent years, however, many supplementary fields have been entered, including credit reports on individuals The service is supported primarily by Chicago commercial banks and trust companies, securities houses, hotels and insurance companies

Reports are in a narrative form, emphasizing the school record, business history, moral responsibility and means of the subject. When corporations or business concerns are investigated, reports also contain bank and trade opinions and, when available, a financial statement Reports carry a summary but no rating

SUPPLEMENTARY SERVICES

Finally, three service organizations furnish financial information which aids in the analysis and determination of the responsibility of certain larger credit risks Two of these services were developed as aids to investment analysis, while the last operates in the highly specialized field of insurance They are Moody's Investors Service, Inc., Standard & Poor's Corporation, and Alfred M Best Company, Inc

The activities of each of these three services have been built around the primary task of furnishing a series of printed volumes or manuals, to subscribers yearly The volumes published by the first two services contain data on the financial condition, earning record, names of officers and directors, history of the business, descriptions of outstanding funded obligations and of outstanding capital securities, and market prices of these securities over a period of years These and similar supplementary data

are furnished on industrial corporations, public utilities, railroads, banks, specialized finance companies, investment trusts, governments, and municipalities that have securities in the hands of the American public. Similar information is contained in Best's manuals on all insurance underwriting organizations, whether or not they have capital stock in the hands of the public.

Estimates of the number of units that come under these classifications vary greatly. The important units in each of the first four of the following divisions are listed or traded on the various stock exchanges in the country, while the important units among the banks and financial organizations, states, and subdivisions are largely dealt in over the counter. The insurance institutions, many of which are mutuals, are those licensed to operate in the United States (see Figure 25).

Figure 25 Classification of Institutions Having Securities Outstanding with a Fairly Active Market

Classification	Estimated Number
Industrial Corporations	3,600
Public Utility Corporations	1,300
Railroads	300
Foreign Government and Subdivisions	400
Insurance Companies	4,000*
Banks and Financial Organizations	1,000
States and Subdivisions	5,000

* The approximate number in existence. Approximately three hundred and twenty have stocks in the hands of the public which are largely traded in over the counter.

Of these seven divisions, the first is of greatest interest to the bank credit department. These thirty-six hundred corporations are the largest business concerns that, sometime in the process of expansion, went to the public for funds. The information compiled by the investment services on these corporations is at times of material supplementary value to credit departments. To some extent, the same is true of data on public utilities, railroads, stock insurance companies, investment trusts, and other financial organizations, especially where the bank credit department has oversight over loans against securities and assists in determining the investment policies of the bank. The only available exact data regarding the number of corporations with securities widely held by the public[3] are the follow-

[3] This subject has been given considerable attention in recent years by the staff of the Securities and Exchange Commission. The twenty-fifth *Annual Report* of the commission for the fiscal year ending June 30, 1959, (p. 61) had the following to say

ing New York Stock Exchange and American Stock Exchange figures 1,395 (115 are foreign issuers) have stocks and/or bonds listed on the New

regarding the number of issuers and their securities on exchanges "As of June 30, 1959, a total of 2,236 issuers had 3,808 classes of securities listed and registered on national securities exchanges, of which 2,631 were classified as stocks and 1,177 as bonds. 1,294 issuers had 1,512 stock issues and 1,124 bond issues listed and registered on the New York Stock Exchange. Thus, 58 percent of the issuers, 57 percent of the stock issues and 65 percent of the bond issues were on the New York Stock Exchange." The *Report* (pp. 66–8) then gave the following picture of the extent of the over-the-counter market by different types of corporations "Somewhat over 700 domestic banks have stocks with 300 or more reported holders which are not on any stock exchange Practically all are common stocks. Their aggregate market value on December 31, 1958, was about $15 billion, which was close to 10 percent of the $155 billion assets on that date of the issuing banks. The corresponding market value of bank stocks on stock exchanges aggregated about $237 million for 24 issues. About 300 domestic insurance companies have stocks with 300 or more reported holders which are not on any stock exchange Nearly all are common stocks. The aggregate market value of their quoted stocks on December 31, 1958, was about $11 5 billion, which was close to 40 percent of their $29 billion assets on that date. The corresponding value of insurance stocks on stock exchanges aggregated about $1.6 billion for 17 issues of 16 issuers. About 500 issuers are registered under the Investment Company Act of 1940, and their aggregate assets are about $20 billion. On December 31, 1958 39 of these issuers, with about $2.2 billion net asset value, had stocks on stock exchanges with about $1.9 billion aggregate market value. Over-the-counter market or redemption values of the remaining issuers securities would bear a close correspondence to their approximate $17.8 billion net asset value About 2,500 additional domestic industrial, utility, and miscellaneous issuers have stocks with 300 or more reported holders which are not on any stock exchange The aggregate market value on December 31, 1958, of their shares was about $32 5 billion. About $2.5 billion consisted of preferred stocks The $30 billion common stocks were of companies with aggregate assets of about $39 billion on that date Nearly all widely-held railroad stocks and a preponderance of widely-held utility and industrial stocks are on exchanges." The *Report* then summarized "In all, some 3,500 domestic corporate issuers (excluding registered investment companies) have stocks with 300 or more reported holders which are not on any stock exchange, and whose aggregate market value on December 31, 1958 was approximately $59 billion. The assets of the issuers having over the-counter common stocks aggregated about $223 billion on that date, of which nearly 70 percent ($155 billion) was of banks As in case of issuers having securities on stock exchanges, the number of such issuers of over the-counter stocks has not changed greatly in recent years. The constant additions are substantially offset by losses through new listings on stock exchanges, mergers, sales of assets, liquidations and reduction in number of shareholders in some instances. Share price changes have kept pace with those of stocks on stock exchanges. Aggregate share values of $238.8 billion on stock exchanges on December 31, 1955, were about 5 3 times the $45 billion over-the-counter values as computed for that date in our 22nd *Annual Report* (1956) and the $312 7 billion stock exchange values on December 31, 1958, were similarly about 5 3 times the $59 billion over-the-counter values as above computed.

"The domestic over the-counter stock values of $59 billion, as computed above, included $15 billion of stocks of banks, which report to their own regulatory agencies. Of the $44 billion of other stock values, about $24 billion, or over 50 percent, were of issuers reporting to the Commission pursuant to requirements of the Securities Exchange Act of 1934. The $24 billion included about $20 7 billion stocks of [1,035] domestic issuers reporting under section 15(d) of the 1934 Act, by reason of registrations of securities for public sale, and about $3 3 billion over the-counter stocks of issuers reporting because they have other securities listed on registered exchanges."

York Stock Exchange;[4] 964 have stocks or bonds listed or traded in on the American Stock Exchange.[5]

Listing or trading[6] privileges on an exchange are not necessarily an indication that the enterprise is a sound credit risk. Corporations whose securities are listed or traded on these exchanges as well as others fail, reorganize, merge, consolidate, or liquidate, just as do smaller concerns where control is closely held.

Moody's Investors Service, Inc.

John Moody, the founder of this concern, published his first compilation of financial and statistical information in 1900. Subsequently this "Encyclopedia of Investments" was extended into five separate volumes covering: industrials; public utilities; transportation companies; govern-

[4] December 31, 1961.

[5] December 31, 1961.

[6] Securities that may be purchased on the American Stock Exchange, unlike those on the New York Stock Exchange, fall into two groups: (*a*) listed and (*b*) unlisted. All securities on the New York Stock Exchange are listed. (From 1885 to 1910 the New York Stock Exchange had an unlisted department where new industrial issues were admitted for trading. See John T. Flynn, *Security Speculation* [New York: Harcourt, Brace & Co., 1934], p. 22.) The securities listed on the American Stock Exchange are so designated because the operating managements of these corporations applied for listing, furnished information to the exchange, and fulfilled all "Requirements for Listing Applications." The information required for listing is comprehensive, including comparative balance sheets and operating accounts, copies of documents relevant to the issue to be listed, incorporation details with all changes to date, the date and place of annual stockholders' meeting, brief physical description of properties, details of funded debt if any, list of subsidiary companies, and, finally, a tabulated list of all cash and stock dividends paid on all classes of stock from the initial payment to the date of application. Information in such detail, however, is not required from corporations whose securities are traded in but not listed. Such issues previously had been traded in over-the-counter or listed on some other exchange, and had a sufficient number of stockholders, in the opinion of the exchange, to constitute an adequate public market. In practically all such cases some information is available regarding the record and financial condition of the corporation in the well-known manuals. In addition, the exchange has access to all information published, which it maintains in files available to the public. The Securities Exchange Act of 1934, however, in addition to requiring the registration of all concerns whose securities were listed on a national stock exchange, provided for the registration by the *exchange* itself of all securities traded in but not listed, which were admitted to trading prior to March 1, 1934. This is in contrast to the requirement that the *management* of listed companies had to make application for registration under this act. As a result, the present unlisted securities that are traded in on the American Stock Exchange represent those that were admitted prior to that date, except in isolated instances where, under provisions of Section 12F of the act, effective May 27, 1936, new securities have been admitted to unlisted trading under the more rigid restrictions imposed by the Securities and Exchange Commission. Stocks and bonds of 782 corporations were listed on the American Stock Exchange and stocks and bonds of 182 corporations were traded in but not listed, as of December 31, 1961.

ments and municipals, and banks, finance, insurance companies, real estate, and investment trusts

Today each of these five publications is an annual bound volume containing basic descriptions of United States, Canadian, and many foreign corporations and investment situations in which there is public investor interest, plus *twice weekly news* issues which keep the basic *information* in the bound volumes constantly up to date Over thirty thousand corporations, financial institutions and municipalities are covered on a regular basis For the size and approximate coverage of each volume see Figure 26

Since 1909 Moody's has also been issuing weekly investment advisory letters on the stock market and the bond market. *Moody's Stock Survey* provides analytical and advisory coverage on approximately seven hundred individual stocks An integral part of the *Stock Survey* is *Moody's Handbook of Widely Held Common Stocks*, which is revised four times annually This volume covers over seven hundred different issues and provides subscribers with price charts, balance sheet and income statistics, and other pertinent data, as well as a characterization of each stock from an investment point of view *Moody's Bond Survey* provides coverage on every segment of the bond market Both new and outstanding issues, general market opinions, and analyses of specific situations appear regularly each week.

Figure 26 Size and Approximate Coverage of Moody's "Encyclopedia of Investments"

Title of Service	No of Units Covered (approx)	No of Pages in Volume (approx.)	No of Pages in Twice Weeklies (approx.)
Industrials	3 800	3 240	2 000
Public Utilities	850	1 900	600
Transportation	1 100	1 640	680
Banks Finance Insurance Real Estate and Investment Trusts	8 300	1 660	730
Municipals & Governments	16 700	2 640	500

Other publications include *Moody's Dividend Record* and *Moody's Bond Record*, both of a specialized nature *Moody's Annual Dividend Record* is a widely circulated year end publication used for income tax purposes It covers over eighty five hundred different stocks and bonds. *Moody's Advisory Reports* are individual analyses on some twenty three hundred securities which the organization's analytical and research depart-

ments have under continuous surveillance. These are available only to bona fide investors on a subscription basis.

The management of investment funds is the largest single part of the Moody organization's business. This highly personalized professional service, equivalent to "investment counsel," is available to both individual and institutional investors, including trust funds of all types, pension funds, corporations, foundations, endowments, and banks.

John Moody developed a code of rating symbols to identify the investment quality of bonds almost half a century ago, and his system has become more widely known and used than any other. *Moody's Bond Ratings* are the accepted yardstick of investment quality on publicly marketed bonds.

Standard & Poor's Corporation

This concern is the result of a merger in 1941 of Standard Statistics Co., Inc., and Poor's Publishing Co. Poor's "History of Railroads and Canals" in 1860 was the first manual on corporation securities.

Among its various publications Standard & Poor's Corporation publishes financial and collateral information daily, weekly, and monthly on corporations with securities in the hands of the public. This particular service, called *Standard Corporation Records*, consists of seven looseleaf binders. The first six contain comprehensive facts: names of officers and directors, history and nature of the business, comparative balance sheets, comparative income statements, provisions of bond issues, details of authorized and outstanding stock, number of times interest requirements are earned, earnings per share on preferred and common stocks, and similar important data. The basic descriptions in these six volumes are continuously revised as corporation statements are issued, with latest developments included. New sections replace the old. The seventh binder is the *Daily Corporation News*. Published five days a week, it provides condensed information that appeared in the press or became otherwise available the preceding day.

Another important credit reference is *Poor's Register of Directors and Executives, United States and Canada*. Published since 1928, this volume of thirty-one hundred pages contains four sections: (1) "Corporation Directory"—approximately twenty-five thousand companies with names of officers, directors, and other executive personnel; (2) "Individuals"—approximately seventy-three thousand names of individual executives, with business and residence address, all corporate affiliations, and other personal data; (3) "Classified Industrial Index"; and (4) "Product Index."

Three more recent services designed for banks are the *Municipal Bond Pricing Service, Dividend Punched Card Service,* and *White's Tax Exempt Bond Ratings* The first two are primarily for banks with IBM equipment. The third is a manual on municipal bonds Standard & Poor's publishes numerous other services used by banks *Industry Surveys, Bond Reports, Daily Dividend, Semi-Weekly Called Bond Record, Listed and Unlisted Stock Reports, Municipal Bond Selector,* and *Bond Outlook* The company also supervises securities portfolios of banks

Alfred M Best Company, Inc

The two manual-publishing services just described are fundamentally investment services The third, Alfred M Best Company, Inc, only incidentally serves investors its fundamental activity being in the nature of credit investigations and analyses in the field of insurance underwriting In the late eighteen nineties, the insurance business in the United States was disturbed by the sudden mushrooming of "wild cat" and "underground" insurance companies Out of this situation, the Alfred M Best Company was incorporated in 1899 to investigate and prepare reports upon the reliability, financial standing, management, and loss of paying ability of insurance companies of all classes Today headquarters are located in New York City, with branch offices in Chicago, Chattanooga, Cincinnati, Dallas, Wellesley Hills, Los Angeles, and Richmond

There are approximately four thousand underwriting insurance institutions licensed to operate in the United States This number includes stock mutual, and reciprocal organizations writing fire, casualty, and life insurance Each of these enterprises is investigated, and the resulting information is made available to subscribers in the form of reports and services, but primarily in the form of two manuals Clients consist of banks, trust companies, insurance agents, brokers, insurance companies, railroads, public utilities, industrial and commercial establishments, and others purchasing large amounts of insurance

In addition to the two manuals, Best's has a number of collateral services In all, Best's issues thirteen annual publications (see Figure 27), supplemented by special reports, four monthly publications and two weekly publications The annual publications are as follows

Best's Fire and Casualty Insurance Reports is a bound volume, approximately 10 inches high, 7 inches wide, and from 1½ to 2 inches thick *Best's Life Insurance Reports* is 7½ inches high, 4½ inches wide, and 1½ inches thick They contain the following extensive information on fire and

casualty and on life insurance companies, respectively: recent financial statement, history of the business, names of the official management, classification of admitted assets, table of underwriting results covering five years, financial exhibit comprising the principal ratios used to analyze the inherent financial soundness of insurance companies, operating results, prices of stocks, transfer agents, dividend rates, types of insurance written,

Figure 27 Best's Annual Publications

Manuals	No. of Units Covered	No. of Pages
Best's Fire and Casualty Insurance Reports*	1,400	1,907
Best's Life Insurance Reports*	900	2,211
	2,300	
Supplementary Annual Publications		
Life Chart of Recommended Companies	256	chart
Life Underwriters' Guide—Underwriting Practices	200	chart
Insurance Guide with Key Ratings	1,450	459
Recommended Insurance Attorneys with Digest of Insurance Laws		910
Directory of Adjusters and Investigations		234
Digest of Insurance Stocks	120	331
Aggregates and Averages		137
Reproduction of Principal Schedules of Casualty and Surety Insurance Companies	106	1,213
Best's Safety-Maintenance Directory		778
Flitcraft Compend		768
Flitcraft Settlement Options		704

* The reports in these two volumes are on the 2,300 larger insurance underwriting organizations. The other 1,700 of the approximately 4,000 underwriting insurance companies in existence are smaller mutual or co-operative organizations, practically all of which confine their activities to a single county or a single city. Some of these enterprises have admitted assets of only a few hundred dollars. They are listed alphabetically and by states with their (1) total admitted assets, (2) annual premiums or assessments, and (3) amount of insurance in force, in the rear of *Insurance Guide with Key Ratings.*

territory covered, income statement, premiums in force, and types of policy written. The supplementary annual publications are utilized largely by the various divisions of insurance activity.

In 1946 *Best's Safety-Maintenance Directory*, an encyclopedia of all known safety devices, products, and equipment in the fields of safety, first aid, hygiene, health conservation, and fire protection, was first published. This volume, published biannually, shows the safety products and all of the latest improvements; it illustrates the hazard and the remedy; it de-

scribes the need and field of use of each product, and it gives the manufacturer of the product and the names and addresses of local dealers and distributors

Monthly and Weekly Publications—Three monthly publications are magazines which cover current news and developments in the fields of (*a*) fire and casualty insurance, (*b*) life insurance, and (*c*) safety engineering Two weekly publications are mimeograph bulletins, covering immediate developments that affect the standing of insurance companies.

Analysis of Statements—Each insurance company files an elaborate annual statement with the Insurance Department of each state in which it is licensed to operate These statements are prepared as of December 31 and are practically uniform throughout the United States. They show, in order, income, disbursements, assets liabilities, and various schedules that tie into the financial statement. Underwriting exhibits and a list of the company's securities are among the schedules included

Financial statements are obtained direct from every insurance company, submitted to an actuarial department, and then analyzed A financial and a general standing rating is assigned on the basis of this analysis. Weight is given in the analysis to the safety factors of each financial statement, which are carefully scrutinized to determine the soundness, liquidity, diversification of assets, yield, and the ratio of real estate and mortgage investments, if any, to total resources No ratings are assigned to new companies or to those in which control has recently changed, until four years of operating experience are available

Service to Banks—Most banking institutions that utilize Best's facilities are interested primarily in service on fire insurance companies and casualty insurance companies Best's provides an annual volume of information on every fire casualty, and surety company In addition, the banker is entitled to make requests during the year for up-to-date information on any number of insurance companies This service is valuable to the mortgage and loan departments of banks, as *Fire and Casualty Insurance Reports* enables them to check the reliability of any fire or casualty company insuring properties upon which the bank holds the mortgages Trust departments handling estates are similarly served in checking the soundness of insurance companies covering insurable properties of estates

Reports are also valuable to loan departments making loans against insurance stocks. Banking institutions located in New York, Chicago, Boston, Philadelphia, San Francisco, Atlanta, and New Orleans not infrequently make loans against insurance company stocks traded in over the counter Best's insurance publications give financial and statistical exhibits on insur

ance companies, including a complete five-year record of the dividends paid by each. Liquidating and intrinsic values are also computed. This information is helpful in checking both the reliability of an insurance company and the valuation of its outstanding stock.

Survey of the Investment Manual Publishing Services

When an annual report of a corporation is received by the three manual-publishing services, the balance sheet and the income account are set up in vertical columns for comparison with the figures of preceding years. The number of times interest is earned and per share earnings are figured; officers, directors, and history are verified; and a hand proof of the revised information is generally mailed to an official of the corporation for detailed verification. No serious effort is made to analyze the inherent financial soundness or trend of the corporation from a credit point of view. The job is fundamentally one of compilation and condensation.

Annual corporate reports of large nationally important corporations, when not carefully analyzed in complete detail, may not readily reveal the real financial condition of the business.[7] No reliable analysis of the financial condition or the trend of a business organization can be made without a thorough investigation by trained investigators who know where to seek the wide array of additional facts needed before putting a business enterprise under the microscope. An audited balance sheet is the place from which to start such an investigation and analysis.

For example, at least nine out of every ten industrial corporations listed on the New York Stock Exchange have a series of subsidiary organizations. The figures contained in the annual reports are generally headed "Consolidated Balance Sheet" and "Consolidated Income Account." These two schedules often represent the sum and substance of available data. Rarely is mention made of intercompany loans and sales or of the number, business, size, financial condition, or financing of subsidiaries. These facts are absolutely necessary for even a superficial analysis of the inherent financial strength of the parent corporation. With the exception of concerns required to render reports to the Securities and Exchange Commission, complete lists of subsidiaries are rarely encountered, and even when they are, it is not necessary for managements to give the addresses of subsidiaries to the Commission.

[7] This subject is analyzed in some detail in Alden Winthrop, *Are You a Stockholder?* (New York: Covici Friede, Inc., 1937). See also Benjamin Graham and David L. Dodd, *Security Analysis* (3rd ed.; New York: McGraw-Hill Book Co., Inc., 1951), and Roy A. Foulke, *Practical Financial Statement Analysis* (5th ed.; New York: McGraw-Hill Book Co., Inc., 1961).

Then again, the balance sheets of corporations that are worth millions of dollars are somewhat complicated, owing to the fact that minor items are grouped together into a limited number of figures No satisfactory analysis is possible without explanations of these grouped items What are they? How did they arise? Why did they change in amount during the year? If assets, are they tangible or intangible?

The item 'Investments, for example, is always a deep, dark mystery Does it represent investments in stock exchange securities? If so, are these investments carried at cost or market? Is the account composed of stocks, bonds, or both? Is any appreciable part of the investment in one security? Is any part treasury stock? Does the item represent investments in subsidiaries? Were any of the securities taken in payment of dobts? Does any part represent stock holdings in any important customers? Satisfactory answers to these and other vital questions may be obtained by interviewing a responsible official of the enterprise

The real service of the manual publishing companies lies in the convenient compilation of data on corporations of general investment interest.

part three

IMPORTANCE AND INTERPRETATION OF FINANCIAL STATEMENTS

UNIVERSITY OF ... Acces ... Date ... JODHPUR

chapter VI

DESCRIPTION OF THE BALANCE SHEET

A LOAN OFFICER MUST UNDERSTAND THE SIGNIFICANCE OF EACH ITEM in a balance sheet, and when he meets an item new to his experience, he must find out what it represents. New items are not unusual, even for a loaning officer who has examined thousands of financial statements, as new wordings and new groupings of asset and liability items are constantly being created by accountants.

After ascertaining what physical asset a particular item represents, the loan officer must go beyond the dollar value to determine the actual value of the asset. As indicated in Chapter VIII, this process often leads into a maze of fascinating but quite relevant bypaths, as a particular asset may actually be worth more or less than the balance sheet value. Variations between actual and stated value may result from inherent limitations in current accounting practice, from ignorance of accounting principles, or from attempts at "window dressing."[1]

Accountants are concerned primarily with the mathematical precision of accounts rather than with the qualitative analysis of the figures. Consequently a skilled banker or a careful financial analyst may often draw more enlightening conclusions from figures than the accountant who certified the statement and who has every iota of supporting data. While the loaning officer of a banking institution or a credit analyst may get along without full technical knowledge of accounting and auditing procedures, he must have the ability to read, analyze, and interpret annual

[1] See Roy A. Foulke, *A Study of The Theory of Corporate Net Profits* (New York: Dun & Bradstreet, Inc., 1949), and *Practical Financial Statement Analysis* (5th ed.; New York: McGraw-Hill Book Co., Inc., 1961), chap. 24.

reports to stockholders, auditors' reports, and supplementary financial statements

DIVISIONS OF CREDIT INFORMATION

Every bit of credit information regarding a business enterprise may be classified under one of three headings whether the concern is a peanut stand on a leased concession on the Atlantic City boardwalk with a nominal capital investment of a few hundred dollars, or the General Motors Corporation with its capital investment of hundreds of millions of dollars and with assets in many countries of the world These categories are fully as important as each leg on a three legged stool and are emphasized throughout this volume

1 Antecedent information, which is the full record of the individuals associated in operating a business enterprise, and the record of the business enterprise itself since inception.

2 Investigational facts, which cover the wide range of information obtained from thorough periodic bank and trade investigations.

3 Financial information, which represents available financial data. When adequate information is available, the analysis may cover (*a*) comparative balance sheets, (*b*) income statements and supplementary facts, (*c*) surplus accounts, (*d*) budgets set up in anticipation of future operations, and (*e*) trial balances If inadequate, the information may be confined to a rumor or a casual statement that a concern has an approximate tangible net investment of $5,000 or $50 000 or $500,000

The data obtained under the first two divisions are largely matters of record and are generally available elsewhere for verification—and not solely by the management of the concern itself Financial information obtained entirely from the management, however, constitutes a direct claim by the concern as to its financial condition and is subject to no further verification. There are modifications to this statement when a well known independent accountant or firm of accountants vouches for the correctness of the figures or when a bank sends its own accounting representative to the concern to draw off a balance sheet or to verify certain figures As a result, the financial information must be analyzed from a point of view somewhat different than for the analysis of other data, since the figures in the great majority of cases[*] are the unconfirmed

[*] Of the active commercial and industrial business enterprises of the country 81 per cent have a tangible net worth of $35,000 or less. Naturally very few of these concerns can afford to use the services of independent certified public accountants.

claim of the operating management of a business enterprise regarding its own condition. There is no doubt that many managements are inclined to overvalue the assets of their businesses and simultaneously to undervalue their liabilities. In fact, in the case of many smaller business enterprises, this process seems to be almost instinctive. The reputation for honesty and integrity of the active management does, however, have a bearing upon the confidence with which one views the figures of a business. This fact is taken up as the first step preparatory to analyzing the figures, in Chapter VIII.

Financial statements from the credit point of view are of five kinds: (1) balance sheets; (2) income statements; (3) reconciliation of surplus in the case of a corporation, or a reconciliation of the net worth in the case of a proprietorship or a partnership; (4) budgets; and (5) trial balances.

The balance sheet is a full list of the assets and liabilities of a business enterprise. The income statement is a schedule showing the income and the expenses for a certain period of time, generally for one year. The reconciliation of surplus or of net worth is a schedule that shows the amount of the item at the beginning of a period, credits or debits during that period, which are often of a unique, fascinating, and unusual character in the case of large corporations, and the final figure, surplus or tangible net worth as the case may be, which is shown in the balance sheet of the same date. An exploration into, and an understanding of the reasons for specific charges to the surplus account often opens up untold possibilities under widely varied accounting practices for the manipulation of profit figures, although less so in recent years. The information in each of the first three schedules is complementary.

A budget is a schedule showing anticipated receipts and disbursements for a period of time made on the basis of the reasonable expectancy of a certain volume of business. The examination of a budget and how it is met gives a banker an insight into the current running operations of a business enterprise. This insight is of inestimable value to him in following and judging the financial condition of a borrowing account.

A trial balance, generally furnished between fiscal dates, is a single schedule showing income and expenses, assets and liabilities, in one form. The trial balance is invaluable to a banker who knows how to interpret it for learning what has transpired since the last balance sheet was prepared. It is, however, a financial statement that few bankers are trained to use.

Balance Sheet

Although the balance sheet lists assets and liabilities, it does not indicate whether an enterprise is making or losing money [3] This financial statement merely indicates the resources and the liabilities of a business enterprise at a particular date The attributes of the balance sheet have been aptly described in the following quotation "Should a picture of the Twentieth Century Limited be taken with a camera with a very fast shutter, a photograph of the train would be obtained in a fixed position. But this picture would not convey to the observer a definite idea as to whether the train were moving forward at a high rate of speed, standing still, or going backward"[4]

In short, the balance sheet is nothing but a snapshot of the financial condition of a business at a given moment. Often that snapshot must be examined with a high powered magnifying glass to ascertain the imperfections, limitations, and difficulties under which the picture was taken and the film developed. In some cases the focus was not properly adjusted and the outlines of the main image are blurred, in other cases the picture is developed perfectly with the clearest possible lines, perfect highlights, and contrasting shadows

Income Statement

The income statement contains the secret of what goes on between successive balance sheets This statement shows the amount of income, expenses, and net profit or loss for a period of time. Sometimes several items are combined and lose their individual identities in a profit and loss account. When this is done, definite expense items are hidden, and the image again is blurred

Reconciliation of Surplus

A separate account is often used to reconcile profit, as shown in the income statement with surplus in the balance sheet The net profit is added to the surplus at the beginning of the period At times un-

[3] Except in a very general way by indicating an increase or a decrease in the surplus account or in the tangible net worth in successive balance sheets. Even these fluctuations may be the result of other factors than profitable or unprofitable operations, such as dividend disbursements, miscellaneous adjustments made through the surplus account, the sale of additional stock, and write-up or write-down of fixed assets.

[4] *Fundamentals of Credit* (New York R. G Dun & Co., 1931), p 30

usual items of income are also added, and unusual charges or losses and dividends are then deducted. The balance is the surplus at the end of the period. An examination of the reconciliation of surplus is essential to ascertain the extent and the nature of other charges that are not put through the income account. These charges are sometimes so important that an accurate picture of the financial condition of a business cannot be had without knowledge of them. In the case of proprietorships and partnerships, the reconciliation of the tangible net worth, though less important, serves the same purpose.

Budgets

There are many forms of budget, but of principal interest here is the estimated income statement, giving a reasonable expectancy of sales, expenses, and income during the next fiscal period. Often the budget is reviewed by a banker to determine the prospects of a business and the extent to which expenses are being reduced or kept in line.

Trial Balances

A trial balance is simply a list of the general ledger balances. Every business enterprise that keeps a complete set of books regularly draws off a trial balance of its general ledger at the end of each month. The general ledger seldom reflects a clear picture of the condition of a business, as there is no separation of assets, liabilities, expenses, and income. When the items are separated, grouped, and properly interpreted, a trial balance does, however, throw light upon the financial condition, the volume of sales, and the details of expenses since the previous closing of the books with a physical inventory.

DESCRIPTION OF BALANCE SHEET

From the point of view of the bank loaning officer or the bank credit analyst, the balance sheet is probably the most important and surely the most used of these five financial statements. He can easily determine whether the financial condition of an enterprise is satisfactory over successive years notwithstanding operating losses if he knows the relationship of the various assets and liabilities in the balance sheet and the seasonal operations of the business, which indicate whether or not liabilities are out of line during the peak of the operating season. Certain operating data, particularly final profit or loss and the reconciliation of surplus, are

valuable when studying the actual current financial strength or weakness of a concern, but are secondary to the necessity of obtaining the most recent balance sheet, understanding its make up, and interpreting the various items in its assets and liabilities With this in mind, we shall give a classification and an explanation of the items on the typical balance sheet.[5]

Every balance sheet is divided into two parts assets and liabilities The assets are the aggregate of all tangible and intangible items making up the available resources the holdings, the possessions, the wealth of a concern. The liabilities are the aggregate of all items that the concern owes either to outside creditors or to its owners The assets and the liabilities must always equal each other, that is the primary principle of double-entry bookkeeping, as initiated by Paciolo in 1494 and as it has come down to us without change through the centuries

Assets

The assets are readily and customarily divided into four groups current, fixed intangible, and miscellaneous

Current Assets —These are assets that are generally converted into cash in the normal course of business operations They consist of (1) cash on hand or in the bank (2) government securities, (3) marketable stocks and bonds when carried not in excess of market and where the spread between the asked and bid price is normally narrow, (4) receivables—accounts, notes, drafts and trade acceptances for the sale of merchandise, (5) merchandise, and (6) advances on merchandise A table of these and of the other typical balance sheet items will be found in Figure 39 on pages 193 to 196

The Securities and Exchange Commission gives a somewhat more restricted explanation of current assets, but the fact that the explanation is not a definition is indicated by the omission of any reference to marketable securities, although in a succeeding paragraph in its instruction book, marketable securities are considered current when they have "a ready market" The Securities and Exchange Commission's explanation of current assets reads as follows

> Items classed as current assets shall be generally realizable within one year However, generally recognized trade practices may be followed with respect

[5] For a more exhaustive treatment and description of balance sheet items, see Roy A Foulke *Practical Financial Statement Analysis* (5th ed New York McGraw Hill Book Co Inc., 1961), chap 4

to the inclusion of items such as instalment receivables or inventories long in process, provided an appropriate explanation of the circumstances is made, and, if practicable, an estimate is given of the amount not realizable within one year.[6]

The item of cash is normally separated into "cash on hand" and "cash in bank." As far as we are concerned, in the interpretation of the balance sheet it makes no material difference whether the item is separated or not. We assume that the item—unless otherwise noted in the balance sheet, the footnotes, or the certificate of the auditor—is cash that can be used at a moment's notice, and that there are no withdrawal restrictions on the cash on deposit in banks. If the cash item is relatively large for the size of the concern, a careful investigation should be made to see that the account does not include postdated checks which might be held in the safe, receipts for expenditures, advances to salesmen, I.O.U.'s, or other memoranda.

Government securities, issued by the Federal government, states, and municipalities, are normally regarded as liquid reserves. These investments may usually be converted quickly into cash to carry larger inventories and larger receivables arising from increased sales, to finance the erection of a new plant or an addition to an old one, to purchase controlling interest in some other corporation, or to carry on an extensive advertising campaign. Government securities are to the business enterprise what paper eligible for rediscount is to a member commercial bank or trust company. These securities normally show considerable price stability as compared to railroad, public utility, or industrial securities, either stocks or bonds.

However, before such securities are included in the current assets, the banker should have a list of them. It may develop that some of the securities represent extremely small communities and have no ready market. In other cases some securities may be in default. They should not be included in the current assets unless they can be readily liquidated.

Marketable securities should be carried as current assets only when not in excess or market. If, for example, securities costing $10,000 have a market value of only $2,000 but are still carried at cost, one would naturally overestimate the ability of the enterprise to withstand some unusual shock. Reports of registrants to the Securities and Exchange Commission must indicate the method of valuing investments, and, if this is not based on current market prices, the aggregate market value must be stated parenthetically.[7] Balance sheets prepared by certified public accountants or sub-

[6] Regulation S-X, *Form and Content of Financial Statements*, Rules 3-13, 5-02 (1-8) (Washington, D. C.: Securities and Exchange Commission, Aug. 20, 1958), pp. 5, 9

[7] *Ibid.*, Rule 5-02-2, p. 9.

mitted by prospective borrowers are often as obscure on this point as Piccadilly in a London fog In such cases no reliable valuation of asset position is possible without additional information

Accounts, notes, drafts, and trade acceptances may be regarded as current assets only when arising from self-liquidating transactions—that is, from business transactions normally turned into cash according to the customary selling terms All such receivables should be unpledged and collectable Adequate reserves should be set up against bad debt losses Receivables due from officers, employees, and subsidiary or affiliated concerns should be grouped under miscellaneous assets Over the years these miscellaneous receivables are least collectible when most needed, since adversities affecting a business enterprise are commonly felt by officers, associates, and employees This rule of excluding miscellaneous receivables from current assets is not universally followed by accountants but is generally observed by experienced credit analysts Many such receivables are created out of a friendly desire to assist some officer, employee, subsidiary, or affiliated concern over a rough spot, often with remote expectations of collection at maturity In a thorough analysis of receivables, the following nine questions should be carefully investigated

1 What normal terms of sale are used by the concern?

2 Do all receivables arise from actual merchandise sales?

3 Have all receivables not arising from actual merchandise sales been eliminated from the current assets and placed among the miscellaneous (slow) assets?

4 What receivables are 30, 60, 90, 180 days, or more past due?

5 What special selling terms, if any, are offered to subsidiary and affiliated concerns, and what proportion of total annual sales is made to these concerns?

6 What amount of receivables, if any, is due from subsidiary or affiliated[8] concerns? Any such receivables should be eliminated from the current assets and placed among the miscellaneous (slow) assets

7 What amount of receivables is due from one or a very few large accounts? This is important for two reasons (a) to check the individual credit responsibilities of important debtors, and (b) to anticipate the effect

[8] From a credit viewpoint, an affiliated concern is one controlled by the same interests as the one under consideration In the case of a parent corporation which has direct and indirect subsidiaries in various complicated layers all concerns in the entire group are affiliates of any one corporation in the group The term also includes enterprises which have no near or distant corporate relationship with each other but in which a controlling stock interest is held by the same individual or group of individuals, who may thus set policies, sometimes unsound in one enterprise to assist another

of bad debt losses on one or more of these accounts. The percentage of annual sales and any special terms made to these accounts should be ascertained.

8. What amount is due from each class of trade that is sold?

9. If different selling terms are used with different products or with different classes of trade, what amount is due under each set of terms?

Wheat and cotton are sold for cash, while cotton gray goods in the New York textile market are sold substantially but not entirely on ten-day net terms. Furniture is often sold to a consumer on a 10 per cent down payment, the remainder to be paid in twenty-four equal monthly instalments. Merchandise obtained under these various terms and likewise the receivables created by these sales constitute current assets. In the case of manufacturers, it is often desirable to have the inventories broken down into raw material, work in process, and finished products, since these elements vary in liquidity. A manufacturer of ladies' coats, with a considerable quantity of finished merchandise left over at the end of a season, for example, might be headed for a substantial loss and financial embarrassment. Merchandise is normally valued at cost or market, whichever is lower.[9] Any exception to this rule should be carefully investigated.

Advances are made against merchandise and to finance manufacturing operations in only a limited number of lines of business activity. These include cold storage warehouses which might make advances against merchandise stored in their own warehouses; and factors and commission mill agents which make advances against merchandise to textile mills, lumber companies, and paper mills. Lumber companies and paper mills, in turn, make advances to individuals who carry on winter logging operations. Other examples are packing companies which finance fruit and vegetable growers, and southern naval stores factors which make advances to producers of rosin and turpentine. These different situations represent normal operations during seasonal peaks. Advances made to finance such activities as winter logging operations and the growing of fruits and vegetables, are liquidated as merchandise is delivered. Advances by cold storage warehouses, textile factors, and naval stores factors, however, are normally paid off after sale of the products. Knowledge of the terms of settlement is therefore important in evaluating advances.

Fixed Assets.—These assets are not normally intended for sale and not

[9] Inventories may be valued in various ways under "cost or market, whichever is lower"—i.e., first-in first-out, base stock, average cost, retail method, standard cost, and last-in first-out. For an explanation and contrast in these various techniques in valuing inventories, see Roy A. Foulke, *Practical Financial Statement Analysis* (5th ed.; New York: McGraw-Hill Book Co., Inc., 1961), pp. 302–310.

readily convertible into cash This classification includes land, buildings, machinery and equipment, tools, furniture and fixtures, and leasehold improvements These assets are invariably of a permanent nature and are not liquidated in the normal course of business, except through earned depreciation and obsolescence

The amount of fixed assets required varies greatly from business to business Usually only fair sized concerns own land for business purposes. Furthermore, manufacturing establishments require substantial investments in machinery, equipment, and tools Retail stores, on the other hand, usually require smaller investments in fixed assets, which consist of furniture and fixtures, showcases and shelves, refrigerators and leasehold improvements Small concerns operating as proprietorships and partnerships often have substantial real estate holdings in the name of the principals, even though the fixed assets used directly in the businesses are of moderate proportions Such holders naturally involve unlimited liability where the owners have not incorporated At times a subsidiary corporation is organized to hold real estate, thereby limiting liability to the parent corporation

Fixed assets are sometimes shown gross on the balance sheet, and an offset in the form of aggregate depreciation is carried on the liability side In such cases the difference between these two amounts must be determined to know the net value of the fixed assets Sometimes the fixed assets are carried net in the balance sheet, with the depreciation already deducted Obviously the preferable form is to show depreciation as a deduction on the asset side, in order that the experienced analyst may judge the adequacy of the depreciation policy This practice also shows the asset at its book value

The Securities and Exchange Commission requires elaborate schedules of fixed assets from concerns that come under its jurisdiction. These corporations must report additions during the year at cost, retirements or sales, other debits or credits, value at the close of the year, and provisions for depreciation, depletion, and amortization [10] A careful analysis of these features is advisable on the part of investment bankers when long term securities are being underwritten for distribution to the public, and on the part of individual investors and speculators who are considering the purchase of stocks or bonds of a corporation. Bank and other short term creditors are concerned primarily with the proportion of tangible net worth the concern has invested in fixed assets and with the location, serviceability, and condition of these assets Adequate maintenance and

[10] Regulation S-X Rule 11-06 p 47

a conservative depreciation policy are necessary for efficient operation throughout the expected life of the assets.

Intangible Assets.—These are given little or no weight for credit purposes. This classification includes (1) good will, (2) patents, (3) copyrights, (4) mailing lists, (5) catalogues, (6) trademarks, (7) bond discount and underwriting expenses, and (8) organization expenses. Corporations with a large good will created through advertising, research, or long successful operation often follow the conservative practice of valuing it nominally on the balance sheet. Weak concerns, on the other hand, may set up fictitious good will in an attempt to window-dress their statements. In fact the term "tangible net worth" represents throughout this volume the sum of all outstanding preferred stock, if any, common stocks, surplus, and undivided profits, less these intangible items.

This naturally does not mean that intangible assets are necessarily without value. A membership in the Associated Press, Inc., for example, is at times sold for real consideration. A nationally advertised brand or trade name may have a substantial sales value. Bond discount, underwriting expenses, and organization expenses, however, have no real worth. Furthermore, the disposal of an intangible asset for a real consideration generally involves the liquidation of a business, as was the case when in 1936 Time, Inc., purchased the good will of the old comic magazine *Life* for $91,801.86 and converted the publication into a weekly pictorial review. For every case where an intangible item has a real value to creditors, there are probably several hundred cases where it is absolutely valueless.

Miscellaneous Assets.—These are assets not included in the preceding three groups. They comprise a long list of items, many of which are peculiar to particular industries. One or more of the following are commonly found in nearly every balance sheet: (1) miscellaneous investments; (2) cash surrender value of life insurance; (3) receivables due from officers and employees; (4) receivables due from or advances to subsidiaries or affiliated concerns; (5) advances to salesmen; (6) prepaid insurance, taxes, rents, and interest;[11] and (7) deferred items.

[11] In 1947 the Committee on Accounting Procedure of the American Institute of Certified Public Accountants issued an "Accounting Research Bulletin" regarding current assets and current liabilities. This material was republished in *Restatement and Revision of Accounting Research Bulletins, Accounting Research Bulletin No. 43* six years later. Here "prepaid expenses such as insurance, interest, rents, taxes, unused royalties, current paid advertising services not yet received, and operating supplies" are considered current assets for *accounting purposes.* The committee is making no definition or classification for *credit purposes.* The classification of prepaid expenses as current assets for *accounting purposes* is then explained as follows: "Prepaid expenses are not current assets in the sense that they will be converted into cash but in the sense that, if not paid in advance, they would require the use of

Together with fixed tangible and intangible assets, this group comprises those assets that are not turned into cash in the normal operations of a business Many are valuable and represent cash expenditures essential for efficient operation

At this stage too much emphasis cannot be laid upon the policy of always ascertaining what every caption in a balance sheet really means The explanation might be simple and naive, but an item that is not clear to the analyst can only result in a weakness in his chain of reasoning

Liabilities

Liabilities fall into three groups current, deferred, and capital

Current Liabilities —These are obligations due within one year and payable in cash, merchandise, or services They are generally incurred in the normal course of business and must be paid at fairly definite dates The debt may be for the purchase of merchandise, interest accrued on notes payable, the premium on an insurance policy, or an instalment due and payable on a mortgage debt

The current liabilities of every enterprise generally consist of one or more of the following items (1) accounts payable, (2) notes payable, (3) loans payable, (4) trade acceptances payable, (5) accruals, (6) deposits, (7) advances from customers, (8) reserves for taxes, interest, or dividends declared, but not paid, (9) reserves for contingencies expected to involve losses, and (10) any maturity of a funded debt which must be met within one year from the date of the balance sheet

Often close maturities on funded debt are not added to current liabilities, thus making possible an overstatement of the net working capital to that extent The analyst must be on guard against such liability omissions Valuation reserves, such as a reserve for bad debts or against inventory losses, are preferably treated as deductions from the respective assets The less conservative practice is to show the reserves on the liability side as offsets to the corresponding assets

In a thorough analysis of the current liabilities, the following seven points should be carefully investigated

1 Are all liabilities due to unrelated concerns, or is some portion due to subsidiary or affiliated enterprises? If some portion is due to related concerns, ascertain the exact amount and how the liability was incurred

current assets during the operating cycle' Very few credit analysts include prepaid items as current assets Moreover there is some reasonable difference of opinion among accountants in their practice regarding the classification of prepaid expenses 'for accounting purposes' as a current asset

2. If a concern obtains merchandise or services from a subsidiary or affiliated concern, ascertain if regular or special terms have been granted, together with the percentage of the total yearly merchandise requirements obtained from this source or sources.

3. If purchases of merchandise are not spread among a larger number of accounts, ascertain the amount due to one or to a few large suppliers. In any such case, also ascertain the purchase terms and the percentage of yearly merchandise requirements obtained from the one or few large suppliers.

4. Ascertain if loans obtained from others are secured or unsecured. If they are secured, what is the security? At the same time ascertain whether guarantees have been given to support the credit of any other enterprises.

5. If there are chattel mortgages or sales liens outstanding, ascertain the assets that are covered and the aggregate monthly payments that must be made.

6. If unpaid wages and taxes are large, obtain a complete explanation.

7. In 1934 the Supreme Court of the United States ruled that a landlord's claim for the unexpired portion of a lease is not provable in case of bankruptcy. In times of stress, when tenants are hard to find, a landlord will often carry a delinquent tenant as long as there is an opportunity to satisfy a rent claim by attaching the tenant's stock and fixtures. As a result, indebtedness for rent frequently pyramids before a failure; the landlord becomes a secured creditor and often obtains the larger part of the assets in the case of smaller enterprises, particularly retailers.[12]

Deferred Liabilities.—These are liabilities that are not due within one year. In general they consist of (1) mortgages, (2) bonds, (3) debentures, (4) that part of outstanding serial notes due more than a year away, and (5) long-term notes. Deferred liabilities might, however, also consist of (6) unearned income, which is a segregated portion of the surplus not yet earned, and (7) minority interests in a consolidated balance sheet, representing the ownership of stock in a subsidiary or subsidiaries by minority groups. The last two items are technical liabilities from an accounting point of view and do not represent liabilities that must be paid.

During the prewar days funded obligations representing mortgages, bonds, debentures, and serial notes adhered to a fairly uniform pattern. A few were reduced yearly by serial payments or sinking fund provisions; others bore various distant maturities, such as the 4 per cent first mortgage bonds of the West Shore Railroad Company due in the year 2361, the

[12] Manhattan Properties, Inc., v. Irving Trust Company, 291 U. S. 320, 54 Sup. Court 385, 78 Law Ed. 825.

5 per cent bonds of the Elmira & Williamsport Railroad Company due in 2862, and the 4 per cent consolidated debentures of the Canadian Pacific Railway Company which are perpetual and non-callable

Funded obligations have been underwritten and distributed by investment banking houses under almost every conceivable title and with an almost infinite number of variations in the customary contractual arrangements between the issuing corporation and the holders As a result there are now outstanding funded debts containing modifications of the unqualified right to a fixed-interest payment and to a repayment of principal on specified dates Participating bonds share in profits beyond the specified rate, while convertible bonds may be exchanged for another type of security, generally stock, at the option of the holder. A speculative element may also be added by use of detachable and non-detachable stock purchase warrants[13] Many of the issues contain so called "acceleration" clauses, under which the entire amount falls due in case of default in paying interest or principal

During recent years there have appeared a substantial number of what have been termed "subordinated" debenture issues of well known corporations These issues are subordinated in principal and interest to what has come to be called "senior," or "prior," debt. Under typical provisions these securities seem to have more of the qualities of a stock than a debt. They seem to be issued in their existing form primarily as a result of the fact that interest on debentures is a charge against earnings before Federal income taxes, while dividends on stock are paid out of earnings after Federal income taxes Senior, or prior, debt is generally defined as including outstanding long-term debts, new purchase money obligations, bank and insurance company borrowings to be incurred in the future, and the renewals or extensions of any such senior, or prior, debt. That certainly covers a lot of ground, especially when trade creditors, who furnish more credit than all other institutions together, generally are not even mentioned Trade creditors are on a par with all unsecured credits in case of financial difficulties

There are also situations where preferred stock has been changed for debt obligations for tax reasons Changing stock into debt obligations may well weaken a financial structure What is happening is that a new type of corporate obligation is coming into use, and from different creditors'

[13] A most complete and fascinating study of bonds, including an extensive list of individual issues, which vary from the so-called standard patterns, is given in Benjamin Graham and David L Dodd, *Security Analysis* (1st ed, New York McGraw Hill Book Co., Inc., 1934), pp 618–26

viewpoint, the possible effects of the creation of such subordinated debentures must be carefully appraised in each individual case.

Furthermore, assets may be pledged, or the indenture may contain provisions weakening the position of short-term creditors. The analyst should determine from his experience and viewpoint (*a*) whether an issue is excessive in amount and (*b*) whether the provisions of the issue are too severe. In case any provision in the indenture is not lived up to, actions of various types are open to the holders of that particular security which are of more than casual interest to short-term creditors.[14]

Capital Liabilities.—These are merely technical liabilities from a bookkeeping standpoint. In the case of a proprietorship or a partnership, the item is known as "net worth" and represents the investment the owners have at stake in the business. In the case of a corporation the net worth is divided into two and occasionally three parts: capital stock, surplus, and undivided profits.[15]

The two primary divisions of capital stock are: preferred stock and

[14] An enlightening study of corporate trustees was made by the Securities and Exchange Commission under Part VI, *Trustees Under Indentures,* of the *Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees,* 1936. E. S. Clark, assistant cashier, The First National Bank of Chicago, has outlined some of those provisions in trust indentures about which the banker may profitably inquire when analyzing a balance sheet showing long-term liabilities: (1) Is the trustee a responsible institution of experience and reputation? (2) What assets are conveyed under the indenture, especially assets other than land, plant, and equipment, so that the position of general creditors will be known in the event of default? (3) What are the restrictive covenants? Such covenants pertain to the payment of dividends, ratio of current assets to current liabilities, or the margin of current assets over liabilities to be maintained, and so-called negative pledge clauses limiting the incurring of liabilities to periods of less than one year and prohibiting the pledging of receivables or inventories and assignment of any general assets not included in the indenture. (4) What are the requirements in the operation of a sinking fund and their effect upon net working capital and net earnings? Have they been met to date? (5) If there is indication of impending technical default, the trustee's position upon default and the penalty clauses to be invoked should be noted. The duty of the trustee to take positive action has been a serious and difficult question of interpretation. (6) The effect of acceleration of maturity, and possible rights to voting power in event of default, should be investigated. (7) Have profitable operations led to overzealousness in exercising a privilege of redemption prior to maturity at the expense of unduly depleting the net working capital? (8) Are there in existence any supplemental indentures? Where preferred stock is outstanding, the indenture should be perused for retirement provisions, accumulation of unpaid dividends, and acquisition of voting power. Indentures covering the issuance of chattels, other than for the purchase of equipment, are a danger signal to creditors. (9) Finally, are there any indenture requirements relating to corporate liability for taxes?

[15] Undivided profits is an item that is quite generally found in the balance sheets of banks and trust companies but rarely in those of commercial or industrial business enterprises.

common stock A corporation invariably has outstanding common stock Some corporations also have outstanding one or several different issues of preferred or preference stocks In addition, preferred stocks have been issued with almost every conceivable speculative feature They have been sold to the public with a par value, without a par value, and with detach able and non detachable warrants They have been made cumulative, non cumulative, convertible, and participating [16] The credit analyst's primary interest is to determine the relation between owned and borrowed capital but any asset or dividend preferences that may affect the company's financial position and borrowing power should also be investigated Accordingly, detailed information should be investigated on two supple mentary features

1 Knowledge of dividend disbursements and of amounts required to meet dividends on senior securities quarterly and yearly during good and poor times The board of directors might "constructively' refuse to declare dividends if not earned, or, on the other hand, they might be less conservative and vote to continue to pay dividends on preferred stocks out of surplus, even if that policy would weaken the corporation In fact it has not been unusual for the principal stockholder or stockholders to be in such need of ready cash that they have insisted on the payment of dividends at the expense of the financial condition and credit standing of the corporation In still other cases one or several of the officers may have bonus arrangements whereby they receive a percentage of the net profits only after stipulated dividends are paid Dividends would then be declared so that the officers might obtain their higher recompense, even though such a dividend policy weakened the working capital position

2 Knowledge of sinking-fund requirements, which may provide that a certain amount of preferred stock be retired yearly or that a certain percentage of the profits be used for this purpose Many corporations have failed to live up to these provisions under which preferred stocks have been issued, but others have attempted to do so even when it meant depleting the net working capital

Ability to meet and adequately to cover sinking-fund and dividend requirements indicates the capacity of management The policies of the operating management and the reasoning on which these policies are based must be learned and understood early in the relationship between a banker and his borrowing client

[16] Graham and Dodd also give just as comprehensive a list of preferred stocks with this great variety of features which differ from the generally accepted patterns as they do of funded obligations *Op cit*, pp 626–31

Figure 28 Statement form for a partnership or individual borrower used by the Chase Manhattan Bank, New York, New York *(page 1)*

(PARTNERSHIP OR INDIVIDUAL)

Name ______________________________

Address ______________ Business ______________

TO – The Chase Manhattan Bank:

For the purpose of procuring credit or any other financial accommodation from you from time to time, direct or contingent, the undersigned represents that the following *is a true statement of the financial condition of the undersigned* ON THE ________ DAY OF ________, 19____ *and of all facts herein set* forth, and for such purpose agrees that you may at any times hereafter assume that the condition and affairs of the undersigned have continued to be substantially as good as herein set forth and that there has been no change materially impairing the ability of the undersigned to pay all claims and demands against the undersigned, unless you shall have been notified in writing to the contrary by the undersigned, and for such purpose the undersigned further agrees to notify you immediately in writing of any substantial change in the condition or affairs of the undersigned. In consideration of your granting any such credit or other financial accommodation to the undersigned, direct or contingent, the undersigned agrees with you as follows as security for the payment of all liabilities of the undersigned to you, direct or contingent, now existing or hereafter arising, you are hereby given a lien upon, and/or rights of set-off against any deposit or other account of the undersigned with you, and all claims, money, stocks, bonds, commercial paper, instruments and other property of the undersigned which have or shall for any purpose come into your possession, custody or control, whether or not accepted for the purpose for which the same is delivered or intended In any one or more of the following events, any and all obligations and liabilities of the undersigned to you, direct or contingent, now existing or hereafter arising, shall thereupon, unless you shall otherwise elect, become and be due and payable forthwith without any demand or notice to the undersigned if it shall appear at any time that any of the statements herein contained is untrue, or if the undersigned fails to notify *you of any material change in the condition or affairs of the undersigned as above agreed, or if any change occurs in the condition or affairs of the undersigned which* materially impairs the ability of the undersigned to pay all claims and demands against the undersigned, or if the undersigned assigns any accounts or transfers or encumbers any assets so as, in your opinion, to materially affect the business or financial condition of the undersigned, or if the undersigned (being an individual) shall die or (being a partnership or *corporation) shall be dissolved, or if the undersigned shall become insolvent (however such insolvency may be evidenced), or make a general assignment* for the benefit of creditors, or suspend the transaction of his, their or its usual business, or fail to pay any obligation to you when the same becomes due, or if a petition in bankruptcy, or a petition or application for composition, extension or reorganization shall be filed by or against the undersigned, or if any judgment or writ or warrant of attachment shall be entered or issued against the undersigned, or if a receiver shall be appointed of any of the property of the undersigned. *No delay on your part in* exercising any power or right hereunder shall operate as a waiver thereof, nor shall any single or partial exercise of any power or right hereunder preclude other or further exercise thereof or the exercise of any other power or right.

FILL ALL BLANKS WRITING "NO" OR "NONE" WHERE NECESSARY

ASSETS				
CURRENT				
Cash on hand and in banks				
U S. Government Securities				
Due from customers (for merchandise sold)				
Notes and Acceptances				
Open Accounts (less Reserves) (show details on Page 2)				
Due from controlled or affiliated concerns for current merchandise transactions only				
Merchandise (show details on Page 2)				
Finished				
In process				
Raw				
Other (itemize)				
Total Current				
FIXED				
Land and Buildings used in operations (how valued?)				
(list mortgages, if any, in liabilities)				
Machinery, Equipment and Fixtures				
Investments (show details on Page 2)				
Controlled or Affiliated Concerns				
Other Bonds or Stocks				
Cash Surrender Value Life Insurance				
Land and Buildings not used in operations				
Other (itemize)				
Total Fixed				
DEFERRED AND MISCELLANEOUS				
Miscellaneous Materials, Supplies, etc.				
Prepaid Expenses—Interest, Insurance, etc.				
Advances to controlled or affiliated concerns for other than current merchandise items				
Due from Partners, Employees, etc.				
Goodwill, Patents, etc.				
Other (itemize)				
TOTAL				

LIABILITIES AND CAPITAL				
CURRENT (due within one year)				
Notes Payable To Banks — Secured				
Notes Payable To Banks — Unsecured				
Notes sold through brokers				
To others for borrowed money				
Notes or Acceptances Payable—Trade				
Acceptances under Letters of Credit				
Accounts Payable				
For merchandise				
Other				
Due to controlled or affiliated concerns				
Due to Partners, Employees, etc. for temporary loans and advances				
Deposits (when payable?)				
Accrued Expenses				
Mortgages and Long Term Notes (due within a year)				
Other (itemize)				
Total Current				
DEFERRED (due after one year)				
Mortgage Debt (give particulars)				
Long Term Notes (when due?)				
Reserve for contingencies				
Reserve for depreciation				
Other (itemize)				
Total Liabilities				
NET WORTH (Itemize Partners' Accounts)				
NET WORTH (Partnership or Individual)				
TOTAL				

Have you any subsidiary or controlled companies? ______ If so, is above a consolidated statement? ______

(OVER)

BCR-24

TYPICAL FINANCIAL STATEMENT FORMS

Many of the larger commercial banks and trust companies have their own special statement forms. The less elaborate forms are printed on two pages, while the more elaborate ones may run to four. In the latter,

generally the first page is lined to receive the list of assets and liabilities, and the second page to receive the income statement and the reconciliation of surplus. The third and fourth pages contain such supporting schedules and supplementary information as a breakdown of receivables, details regarding life insurance carried, segregations of investments, real estate and mortgages, and details of contingent liabilities. This supple-

Figure 28 (*Continued—page 2*)

ACCOUNTS RECEIVABLE – CUSTOMERS		NAMES OF LARGEST CUSTOMERS
Not due		
Past due 1 to 30 days		
Past due 31 to 60 days		
Past due 61 to 90 days		
Past due 91 to 120 days		
Over 120 days Past due		
Total		
Less Reserve for doubtful accounts		
Reserve for discounts		
Total as per Statement (Page 1)		

MERCHANDISE INVENTORY

Merchandise on hand		As of statement date, what is amount of	
" in warehouse		(1) Merchandise carried over from prior years or seasons?	
" consigned to others		(2) Unsalable or obsolete merchandise on hand?	
" in transit		(3) Merchandise consigned to you?	
Total		(4) Unpaid duty not included in liabilities?	
Less Reserves (if any)			
Total as per Statement (Page 1)			

(1) Does inventory represent physical count? If so, by whom?

(2) Describe in detail the basis of valuation

(3) State the extent of accountants' verification, if any

(4) Is merchandise consigned to you included in assets?

(5) Explain how contractors' accounts, if any, are handled in your statement

(6) At what time of year is inventory highest? lowest?

(7) Give date (or dates) on which inventory is taken and books are closed

INVESTMENTS:

No. shares (stock) or par value (bonds)	Description	Registered in name of	As of statement date: Carried on books at	As of statement date: Market or realizable value	Dividends or interest received in past 12 months

CONTINGENT LIABILITIES AND COMMITMENTS	
Endorsed notes receivable, acceptances, or drafts discounted or sold	
Accounts receivable pledged or assigned	
Endorsements or guarantees for affiliated interests	
Endorsements or guarantees for others	
Unused portion of commercial letters of credit outstanding	
Amount of any unsettled claims or suits pending against firm or individual not appearing on books as liabilities	
Amount of purchase commitments outstanding at statement date	
Amount of unfilled sales orders at statement date	
State any other contingent liabilities	

mentary information is extremely valuable in determining the financial responsibility of a business enterprise.

The less elaborate blanks are often printed on long sheets. The details of assets and liabilities are requested on the first page, and all other data on the second page. The income statement and the reconciliation are

Figure 28 (*Continued—page 3*)

PROFIT AND LOSS ACCOUNT. for ____ months ended ____ 19 __

Gross Sales

Less: Returns, Allowances and Discounts

Net Sales

Less: Cost of Sales

Gross Profit on Sales

Less: Salaries of Partners or Proprietor

Other General and Administrative Expenses

Selling Expenses

Net Operating Profit

Other Income: Interest and Dividends

Miscellaneous

Gross Income

Less: Interest

Bad Debts

Depreciation

Miscellaneous

Net Profit before Withdrawals

Less: Withdrawals

Carried to Net Worth

Adjustments of Net Worth:

Additions: ____

Total ____

Deductions: ____

Change in Net Worth for the above period

Net Worth period beginning

Net Worth period ending

INSURANCE:

Form	Carried on	Beneficiary	Assignee	Amount
Fire........	Merchandise			
Fire........	Buildings and Equipment			
Credit......	Accounts and Notes Receivable			
Life........	Partners, Executives, etc.			
Other Kinds				

BANK ACCOUNTS:

Names of Banks	Credit Lines Arranged	Amounts in use at statement date	On what Basis (endorsements, receivables, collateral, etc.)

(OVER)

condensed into one continuous schedule the other schedules and supplementary information also being somewhat condensed These forms provide for all of the information usually available on smaller business enterprises as the schedules and the supplementary information requested on the typical four page form rarely apply to them Copies of four page

Figure 28 (*Continued—page 4*)

TRADE REFERENCES

Name of Largest Creditors	Address	Amount owing at statement date

NET WORTH OF PARTNERS OR INDIVIDUAL OUTSIDE THIS BUSINESS
(Indicate special partners, if any

Name	Net Worth outside this business	Name	Net Worth outside this business

Give date of expiration of partnership agreement
How long is special capital to be left in business

GENERAL INFORMATION

Maximum total current liabilities last year $ Date

Minimum total current liabilities last year $ Date

Are controlled companies financed entirely by you

If not, how do they borrow Give amount outstanding at statement date

Give amount of loans, if any against cash surrender value of life insurance

To what extent, if any have you pledged any assets during past year?

Were any of the assets pledged at statement date? If so, give details

What are your customary terms of sale? of purchase?

Do you employ Certified Public Accountant(s) to audit your books regularly?

Were books audited by Certified Public Accountant(s) at statement date? If so, please have certificate below signed

PLEASE SEND COPY OF ACCOUNTANTS' REPORT WITH THIS FORM

Please sign here

Date Signed by

I/we have audited the accounts of for the period from to and certify that in my/our opinion the above Balance Sheet and Profit and Loss Statement truly set forth the financial condition of at and the results of its operations for the period, subject to the following qualifications

Date signed

Certified Public Accountant(

statement blanks suitable for corporations and large firms and two-page blanks suitable for corporations, small firms, and individuals are presented in this chapter. One additional four-page form is given in the typical bank credit file inserted between Chapters I and II. All blanks cover about the same essential ground, with particular emphasis on different items or phases of supplementary financial information.

Figure 29 Statement form for an individual borrower used by the Mellon National Bank and Trust Company, Pittsburgh, Pennsylvania (*front*)

PERSONAL STATEMENT (Confidential)

TO MELLON NATIONAL BANK AND TRUST COMPANY

Name____________________ Address____________________

For the purpose of procuring and maintaining credit with Mellon National Bank and Trust Company, the undersigned submits this information and warrants it to be a true and accurate statement of its financial condition on the date here below written. The undersigned further agrees that if any change occurs which would materially lessen its means or ability to pay all claims or demands against it, the undersigned will immediately and without delay notify the said Bank of such change in its financial condition, and until such notification has been received, the Bank may continue to rely upon the information herein given as a true and accurate statement of the financial condition of the undersigned

FINANCIAL INFORMATION FURNISHED AS OF CLOSE OF BUSINESS (Month)__________ (Day)______ 19___

ASSETS				LIABILITIES			
Cash on hand and in Banks				Notes payable to Banks			
U S Gov Securities—see schedule				Secured			
Listed Securities—see schedule				Unsecured			
Unlisted Securities—see schedule				Notes payable to relatives			
Accounts and Notes Receivable Due from relatives and friends				Notes payable to others			
				Accounts and bills due			
Accounts and Notes Receivable Due from others—good				Accrued taxes and interest			
				Other unpaid taxes			
Accounts and Notes Receivable Doubtful				Mortgages payable on Real Estate—see schedule			
Real Estate owned—see schedule				Chattel Mortgages and other Liens payable			
Real Estate Mortgages owned							
Automobiles				Other debts—itemize			
Personal property							
C.S.V. of Life Insurance							
Other assets - itemize							
				TOTAL LIABILITIES			
				NET WORTH			
TOTAL ASSETS				TOTAL LIAB AND NET WORTH			

SOURCE OF INCOME		PERSONAL INFORMATION
Salary	$	Business or Occupation Age
Bonus and commissions	$	
Dividends and interest	$	Partner or officer in any other venture
Real Estate income	$	
Other income—itemize	$	Married Children
		Single Dependents
TOTAL	$	

CONTINGENT LIABILITIES		GENERAL INFORMATION
As endorser or comaker	$	Are any assets pledged?
On leases or contracts	$	Are you defendant in any suits or
Legal claims	$	legal actions?
Provision for Federal Income Tax claim	$	Are there any judgments unsatisfied against you?
Other special debt	$	Have you ever been through bankruptcy or made settlement with creditors?

(SCHEDULES ON REVERSE SIDE)

LEAVE NO BLANK SPACES INSERT WORD "NONE" IN ABSENCE OF ANY AMOUNT

CR 7 REV 1/58

The major central reserve city banking institutions generally use the four-page blanks Large commercial banks and trust companies generally have several statement forms one for corporations, one for partnerships, one for proprietorships, one for individuals seeking small loans, and in certain sections of the country, one for farmers or stockmen The Bank Management Commission of the American Bankers Association has de

Figure 29 (Continued) (*Reverse*)

MELLON NATIONAL BANK AND TRUST COMPANY

LEAVE NO BLANK SPACES. INSERT WORD NONE IN ABSENCE OF ANY AMOUNT

SCHEDULE OF U S GOVERNMENTS STOCKS AND BONDS OWNED

DESCRIPTION	IN NAME OF	MARKET VALUE	IF PLEDGED STATE WHERE

SCHEDULE OF MORTGAGES OWNED

DESCRIPTION OF PROPERTY COVERED	DATE OF ACQUISITION	IN NAME OF	MATURITY	AMOUNT

SCHEDULE OF REAL ESTATE OWNED

DESCRIPTION AND LOCATION OF PROPERTY AND IMPROVEMENTS	DATE OF ACQUISITION	TITLE IN NAME OF	APPRAISED VALUE	MORTGAGE			TAXES AND TO
				AMOUNT	IN US	INSURANCE	

SCHEDULE OF LIFE INSURANCE CARRIED

AMOUNT	NAME OF COMPANY	BENEFICIARY	CASH SURRENDER VALUE	LOANS

LIST BANKS FINANCE COMPANIES AND OTHER REFERENCES WHERE CREDIT HAS BEEN OBTAINED

NAME AND LOCATION	HIGH CREDIT	BASIS	OWE	PAST DUE

LIST OTHER BANKS WITH WHICH YOU HAVE ACCOUNTS

NAME OF BANK	NAME OF BANK

The undersigned certifies that both sides hereof and the information inserted herein has been carefully read and is true and correct.

________________ 19______
Date.

____
Signature.

signed statement blanks covering these particular types of borrower and also one for hotels.[17]

Direct Loans by Federal Reserve Banks

The Federal Reserve Act amendment of June 19, 1934, permitted Federal Reserve Banks to make so-called "working capital" loans either through the medium of commercial banks, trust companies, and other financing institutions or direct to established industrial or commercial businesses. This law, however, permitted direct loans to established industrial and commercial businesses only when authorized by the Board of Governors. The Board of Governors subsequently granted blanket authority to each of the twelve Federal Reserve Banks to extend such accommodation directly on their own responsibility without reference to Washington. The underlying principle of the original Federal Reserve Act was that the operations of each Federal Reserve Bank would be adapted to the peculiar needs of its own district and would be administered by persons residing in and familiar with the problems of that district. Accordingly, the Board of Governors has prescribed no uniform forms to be used in making application to Federal Reserve Banks for working capital, but has left to each the task of preparing forms suitable to the needs of its district.

Since that time the Federal Reserve Banks have developed their own long and short forms for the various classes of borrower. The statement blank of the Federal Reserve Bank of New York given in Figures 30A and 30B (pages 160 to 161) is the so-called "short order" for firms. The statement blank given in Figures 31A–31D (pages 162–165) is the "long form" for firms.

Specialized Forms of National Credit Office, Inc.

The statement form and the so-called "Accountant's Supplementary Information" blank, used by the National Credit Office, Inc., are unique in their application and completeness. The statement of financial condition is mailed to every concern upon which National Credit Office, Inc., issues a credit report. One page of this form requests the usual balance sheet information with names of depository banks, insurance coverage, and class of accountant, if one is used. The second page requests the

[17] Copies of these blanks may be purchased by banking institutions for their own daily use at moderate prices from the Bank Management Commission of the American Bankers Association, New York City.

income figures, the reconciliation of surplus, supplementary details regarding the condition of receivables, merchandise, investments, and taxes.

When this initial form is returned to the National Credit Office, Inc., the Accountant's Supplementary Information blank is mailed to the ac-

Figure 30A Federal Reserve Bank of New York Short Statement Form for Partnerships (*front*)

Form CR 9
Statement Form Suggested By
Federal Reserve Bank of New York

FINANCIAL STATEMENT
As of ______ 19__

PARTNERSHIP
(SHORT FORM)

NAME ______
BUSINESS ______ DATE ESTABLISHED ______
ADDRESS ______

We make the following statement of all the assets and liabilities of this partnership at the close of business on the date indicated above to ______
(Name and Location of Financial Institution)
and give other material information for the purpose of obtaining advances on notes and bills bearing our signature, endorsement or guaranty and for obtaining credit generally upon present and future applications.

BALANCE SHEET

ASSETS		LIABILITIES and NET WORTH	
Cash on Hand	$	Notes Payable to Banks — Unsecured Direct borrowings only	$
Cash in Banks		Notes Payable to Banks — Secured Direct borrowings only	
Notes Receivable — Current & Collectible From customers, excluding affiliates		Notes Payable to Trade Suppliers Excluding affiliates	
Accounts Receivable — Current & Collectible From customers, excluding affiliates		Notes Payable for Machinery & Equipment Due within one year	
Due from Affiliates — Current & Collectible For sale of goods on regular terms		Accounts Payable to Trade Suppliers Excluding affiliates	
Inventory		Advances & Deposits from Customers	
Life Insurance — Cash Surrender Value (Do not deduct loans)		Loans against Life Insurance	
Securities — Readily Marketable U. S. Government & listed on Stock Exchanges		Due to Affiliates	
		Due to Partners	
Total Current Assets	$	Due to Relatives & Friends For loans, advances & other payables	
Securities — Not Readily Marketable Unlisted stocks & bonds		Real Estate Mortgages Payable Mortgages & installments due within one year	
Investments in Affiliates		Accrued Liabilities For taxes, wages, interest, etc.	
Due from Affiliates Loans, advances & other receivables			
Mortgages Owned		Total Current Liabilities	$
Land & Buildings (Do not deduct mortgages or depreciation reserve)		Notes Payable for Machinery & Equipment Due after one year	
Leasehold Improvements (Do not deduct amortization reserve)		Real Estate Mortgages Payable Due after one year	
Machinery, Equipment, Furniture & Fixtures Do not deduct purchases or depreciation reserve		Other Deferred Liabilities Due after one year	
Notes & Accounts Receivable Past due, slow or doubtful of collection			
Due from Partners Loans, advances & other receivables		Total Liabilities	$
Due from Employees, Relatives & Friends Loans, advances & other receivables		Depreciation & Amortization Reserves	
Prepaid Expenses Taxes, insurance, interest, rent, etc.		Other Reserves	
Goodwill, Patents, Trademarks, etc.			
		Net Worth — General Partners' Account	
		— Special Partners' Account	
TOTAL ASSETS	$	TOTAL LIABILITIES & NET WORTH	$

OPERATING STATEMENT—For the ______ month period ended ______ 19__

Gross Sales	$	Administrative, General & Selling Expenses (Incl. depreciation & amortization $______)	
Less Discounts, Returns & Allowances		Net Operating Profit	$
Net Sales	$	Other Income	
Cost of Sales (Including depreciation & amortization $______)		Other Expense (Incl. bad debts $______)	
Gross Profit	$	Net Profit for the Period	$

Opening Inventory $______, Closing Inventory $______ Basis of Inventory Valuation ______

RECONCILIATION OF NET WORTH—For the ______ month period ended ______ 19__

Net Worth—Beginning of Period		$	Carried Forward		$
Additions to Net Worth:			Deductions from Net Worth:		
Net Profit for the Period	$		Partners' Salaries and Other Withdrawals	$	
Partners' Capital Contributions					
Forward		$	Net Worth—End of Period		$

(Continued on Reverse Side)

NOTE: The use of Form CR 108 is suggested for a more detailed presentation of the financial condition of a partnership.
[illegible]

countant who audited the books for information about the scope of his audit. As soon as these schedules are received, they are printed by offset and distributed immediately by the National Credit Office, Inc., to interested members, banks, and mercantile houses.

Figure 30B Federal Reserve Bank of New York Short Statement Form for Partnerships (*reverse*)

SUPPLEMENTARY INFORMATION

NOTE: The following data should be furnished as of the same date as this Financial Statement. Fill in all spaces; insert "NONE" where appropriate.

Notes Receivable — Customers — Original Notes $______, Renewed Notes $______; Past Due Notes $______, Reserve for Doubtful Notes $______

Accounts Receivable — Customers — Not Due $______, Past Due—less than 3 months $______, 3 to 6 months $______, more than 6 months $______; Reserve for Doubtful Accounts $______

Regular Selling Terms — ______

Inventory — Raw Materials $______, In Process $______; Finished Goods $______, Supplies, etc $______ Slow Moving or Obsolete $______; Pledged $______, On Consignment to Others $______ Goods on Consignment from Others $______

Securities — Describe each investment and indicate basis of valuation shown ______

Registered owner of securities ______

Notes & Accounts Payable — Renewed Notes $______, Past Due Notes $______, Past Due Accounts $______

Regular Purchasing Terms — ______

Current Liabilities — High & Low Points — Latest full fiscal year

High Point $______ on ______ 19__

Low Point $______ on ______ 19__

Contingent Liabilities — As of the date of this financial statement, the partnership had no contingent liabilities, except as follows Notes Receivable Discounted or Sold $______, Accounts Receivable Assigned or Sold $______, Accommodation Endorser Guarantor or Surety $______; Mortgage Bonds $______, Leases $______, Purchase Commitments for Merchandise $______, Contracts for Building Construction, Improvements or Equipment $______; Claims for Taxes $______, Other (describe) ______

Life Insurance — On Partners for Benefit of Partnership Face Amount $______, Persons Insured ______

Land & Buildings — Location and Description	Cost with Improvements	Assessed Value	Market Value	Book Value	Mortgages Payable	Mortgage Payments Due Within one Year	Taxes Assessments Mortgage Interest Due & Unpaid
	$	$	$	$	$	$	$

The title to all of the above described properties is solely in the name of this partnership, except as follows ______

Pledged, Assigned or Hypothecated Assets — Describe all assets not noted elsewhere in this statement as having been pledged assigned or hypothecated and indicate the liabilities which they secure ______

As of the date of this financial statement, this partnership had not pledged, assigned, hypothecated or transferred the title to any of its assets, except as noted on this form or on a supporting schedule, nor has any such action been taken since that date, except as follows (give details) ______

Legal Actions — No lawsuits, claims, judgments or other legal actions are outstanding or pending against the partnership or any partner and, to the best of our knowledge, no legal actions are to be started against the partnership or any partner, except as follows (give details) ______

Insurance Coverage — Fire Insurance Inventory $______, Buildings $______, Machinery & Equipment $______, Furniture & Fixtures $______; Indicate if policies have extended coverage endorsement ______, Use & Occupancy Insurance $______, Liability Insurance Autos & Trucks $______, General Public $______; Burglary Insurance $______; Fidelity Bonds $______; Other Insurance (describe) ______

Date of latest independent analysis of insurance ______ Indicate adequacy of coverage ______

Ownership — List all General and Special Partners: Name (Designate General Partner "G P" and Special Partner "S P")	Age	Capital Contribution	Current Annual Compensation from Partnership	Partners Personal Financial Data: Date	Outside Net Worth	Direct Outside Debts Including Mortgages	Liability as Co maker Guarantor Endorser etc
		$	$		$	$	$

Our ______ (Written or Oral) Partnership Agreement went into effect on ______ (Date) and expires on ______ (Date). The responsibility of the Special Partners for the partnership's debts is limited to ______ until ______

Affiliated Companies & Interests — Give names, extent of interest, and nature of interrelations ______

Accounting Data — Name of Independent Accountant ______; Indicate if Certified Public Accountant ______, Frequency of Independent Audits ______; Date of Latest Independent Audit ______, Date of Fiscal Year End ______; Date of Latest Physical Inventory ______

Certification — This is to certify that the foregoing figures were taken from the books and records of this partnership and that they and all other statements on this form and on any supporting schedules are true and give a correct showing of the financial condition of the partnership as of the date indicated IN THE EVENT OF ANY MATERIAL ADVERSE CHANGE IN THE FINANCIAL CONDITION OF THIS PARTNERSHIP, WE AGREE TO NOTIFY THE FINANCIAL INSTITUTION NAMED HEREIN IMMEDIATELY IN WRITING

Signed this ______ day of ______, 19__

______ (Partnership Name)

By ______ (Signature), General Partner

NOTE When there is no written partnership agreement all the partners should sign.

IMPORTANT: If an audit was made as of the date of this statement, a copy of the accountant's report should be submitted herewith.

NOTE: If space is insufficient, separate schedules, which should be clearly identified as being part of this statement, may be attached hereto. Such schedules should be dated and signed in the same manner as this statement.

Additional Explanatory Information

No matter how complete a statement form may be, additional informa tion is always needed by the analyst Various questions arise as he trans fers the figures from the statement form to his comparative statement

Figure 31A Federal Reserve Bank of New York Long Statement Form for Partnerships (*page 1*)

Form CR 09
Statement Form Suggested By
Federal Reserve Bank of New York

FINANCIAL STATEMENT
As of 19

PARTNERSHIP
LONG FORM

NAME
BUSINESS DATE ESTABLISHED
ADDRESS

We make the following statement of all the assets and liabilities of this partnership at the close of business on the date indicated above to

Name and Location of Financial Institution

and give other material information for the purpose of obtaining advances on notes and bills bearing our signature endorsement or guaranty and for obtaining credit generally upon present and future applications.

BALANCE SHEET

ASSETS		LIABILITIES and NET WORTH	
Cash on Hand	$	Notes Payable to Banks — Unsecured Direct borrowings on Sch No. 1)	$
Cash in Banks Sch N		Notes Payable to Banks — Secured Direct borrowings on Sch N)	
Notes Receivable — Current & Collectible From customers, excluding affiliates Sch No.)		Notes Payable to Trade Suppliers Exc affiliates	
Accounts Receivable — Current & Collectible From customers etc affiliates Sch N 3		Notes Payable for Machinery & Equipment Due w one year	
Due from Affiliates — Current & Collectible For sale of goods on regular terms		Accounts Payable to Trade Suppliers Excl affil es	
Inventories — Raw Materials Sch N		Advances & Deposits from Customers	
— Supplies Sch No 4		Due to Affiliates For current purchases of mod etc	
— Goods in Process Sch No		Due to Affiliates For loans, advances & other payables	
— Finished Goods Sch N		Due to Relatives & Friends For loans dv nces & other payab es	
Life Insurance — Cash Surrender Value Do not deduct loans Sc N		Loans against Life Insurance Sch N	
Securities — Readily Marketable U Govt & listed Stock Exch ges Sc No. 6		Real Estate Mortgages Payable Sch No. 0 M rtgages and installments due w one year	
		Real Estate Taxes & Assessments Payable (Sc No	
		Accrued Liabilities For other taxes, wages, interest etc	
Total Current Assets	$	Due to General Partners	
Securities — Not Readily Marketable Unlisted stock nd bond Sch N 6)		Due to Special Partners	
Investments in Affiliates Sch No. 6)			
Due from Affiliates Loans dv nces & other receivables Sch N			
Mortgages Owned Sch No. 8)			
		Total Current Liabilities	$
Land & Buildings — Used in Business (Do not deduct mortgages or depreciation reserve Sch No 9		Notes Payable for Machinery & Equipment Due after one year	
Land & Buildings — Not Used in Business Do not deduct mortgages or deprec reserve Sch. No. 9		Real Estate Mortgages Payable Due after one year (Sc No 0	
Leasehold Improvements Do not deduct amortization reserve)		Other Deferred Liabilities (itemize) Due after one year	
Machinery & Equipment Do not deduct mortgages or deprec tion reserve			
Furniture & Fixtures Do not deduct mortgages or depreciation reserve			
Trucks, Automobiles, etc. Do not deduct mortgages depreci ion reserve			
Patterns, Tools, Dies, etc.		Total Liabilities	$
		Depreciation Reserves-Buildings	
Notes Receivable P st due or doubtful of collection (Sch N		-Machinery & Equipment	
Accounts Receivable Slow or doubtful of collection Sch No. 3)		-Furniture & Fixtures	
Due from Partners Loans advances & other receivables Sch N 1		Trucks, Automobiles, etc.	
Due from Employees, Relatives & Friends Loans, dv nces & other receivable Sc N		Amortization Reserve-Leasehold Improvements	
Prepaid Expenses Taxes insurance interest rent etc		Other Reserves (itemize)	
Goodwill, Patents, Trademarks, etc.			
		Net Worth — General Partners Account	
		— Special Partners Account	
TOTAL ASSETS	$	TOTAL LIABILITIES AND NET WORTH	$

(Continued on Next Page)

CR. 109 2-5M-4-55

sheet, particularly if he has figures for previous years. A noticeable increase or decrease in any item—receivables, merchandise, due from officers or employees, current liabilities, net sales, net profits—calls for an explanation. What brought about the increase or the decrease? Then the policy that brought it about must be evaluated. As a result of these changes in the financial set-up, the concern is either stronger or weaker financially—

Figure 31B Federal Reserve Bank of New York Long Statement Form for Partnerships (*page 2*)

—2—

BALANCE SHEET SCHEDULES

NOTE: The following data should be furnished as of the same date as this financial statement. Fill in all spaces; insert "NONE" where appropriate. If space is insufficient, separate schedules, which should be clearly identified as being part of this statement, may be attached hereto. Such schedules should be dated and signed in the same manner as this statement.

No. 1 — Banking Relations — List all bank accounts

Name and Location of Bank	Cash Balance	Amount of Loan	Indicate How Loan is Endorsed, Guaranteed or Secured
	$	$	

No. 2 — Notes Receivable — Original Notes $ ________ ; Renewed Notes $ ________ ; Past Due Notes $________ ; Total $________ ; Less Reserve for Doubtful Notes $ ________ , Net $ ________ .

Regular Selling Terms: ________

No. 4 — Inventory — *Readily Saleable* $ ________ ; *Slow Moving & Obsolete* $________ ; Total $ ________ ; Less Reserve (If Any) $________ ; Net $ ________ . Inventory Pledged $ ________ ; On Consignment to Others $________ . *Goods on Consignment from Others* $________

Basis of Inventory Valuation: ________

No. 3—Accounts Receivable—Not Due (Original Terms) $ ________ ; Past Due—less than 3 Months $________ , 3 to 6 Months $ ________ , more than 6 Months $________ ; Total $________ , Less Reserve for Doubtful Accounts $________ , Net $ ________ .

Inventory High & Low Points — During latest full fiscal year

	High Point		Low Point	
	Date	Amount	Date	Amount
Raw Materials		$		$
Finished Goods				

No. 5 — Life Insurance — List all policies in names of partners for benefit of partnership

Person Insured	Insurance Company	Type of Policy	Face Amount of Policy	Total Cash Surrender Value	Total Loans Against Policy	If Assigned Indicate To Whom
			$	$	$	

No. 6 — Securities & Investments — List all stocks, bonds, etc

Face Value (Bonds) No. of Shares (Stocks)	Description of Security (Designate Readily Marketable "R.M." Not Readily Marketable "N.R.M." and Affiliates "A.")	Registered Owner	Cost	Market Value	Book Value	If Pledged, Indicate To Whom
			$	$	$	

No. 7 — Due from Affiliates —

Name of Affiliate	Amount of Debt	Age of Debt	Nature of Debt	If Secured, Describe Security	Date Payment Expected
	$				

No. 8 — Mortgages Owned —

Location and Description of Mortgaged Property	Assessed Value	Market Value	Amount of Owned Mortgage	Mortgage Interest Due & Unpaid	Indicate if 1st or 2nd Mortgage	Amount of Prior Mortgage
	$	$	$	$		$

No. 9 — Land & Buildings —

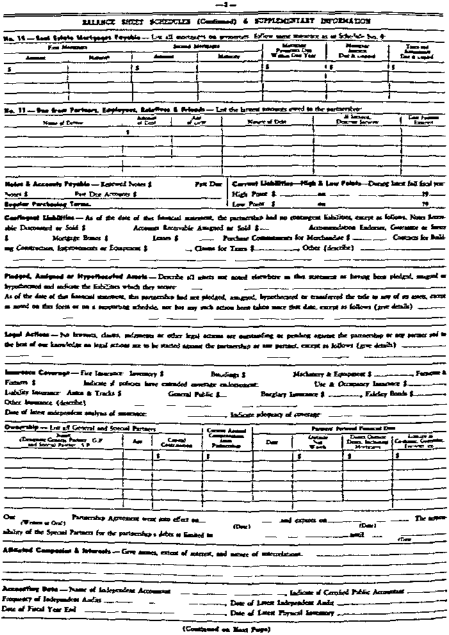
Location and Description	Used in Business?	Cost with Improvements	Assessed Value	Market Value	Book Value	Annual Gross Rental Income	Annual Net Rental Income (Before Deprec.)
		$	$	$	$	$	$

The title to all of the above described properties is solely in the name of this partnership, except as follows ________

(Continued on Next Page)

a better risk or a poorer one. If the account is relatively new at the bank and this is the first financial statement to be obtained, then a request should be made for figures covering operations for at least the two preceding fiscal years, assuming that the concern has been in existence that length of time, and additional information should be sought if important

Figure 31C Federal Reserve Bank of New York Long Statement Form for Partnerships (*page 3*)



—3—

BALANCE SHEET SCHEDULES (Continued) & SUPPLEMENTARY INFORMATION

No. 10 — Real Estate Mortgages Payable — List all mortgages on properties. Follow same sequence as in Schedule No. 4

First Mortgages		Second Mortgages		Mortgage Payments Due Within One Year	Mortgage Interest Due & Unpaid	Taxes and Assessments Due & Unpaid
Amount	Maturity	Amount	Maturity			
$		$		$	$	$

No. 11 — Due from Partners, Employees, Relatives & Friends — List the largest amounts owed to the partnership

Name of Debtor	Amount of Debt	Age of Debt	Nature of Debt	If Secured, Describe Security	Last Payment Received
	$				

Notes & Accounts Payable — Renewed Notes $ Past Due Notes $ Past Due Accounts $

Regular Purchasing Terms.

Current Liabilities—High & Low Points—During latest full fiscal year
High Point $ ________ on ________ 19____
Low Point $ on 19____

Contingent Liabilities — As of the date of this financial statement, the partnership had no contingent liabilities, except as follows. Notes Receivable Discounted or Sold $ Accounts Receivable Assigned or Sold $____ Accommodation Endorser, Guarantor or Surety $ Mortgage Bonds $ Leases $ ____ Purchase Commitments for Merchandise $ ______ Contracts for Building Construction, Improvements or Equipment $ ____, Claims for Taxes $__________, Other (describe) ________

Pledged, Assigned or Hypothecated Assets — Describe all assets not noted elsewhere in this statement as having been pledged, assigned or hypothecated and indicate the liabilities which they secure ________
As of the date of this financial statement, this partnership had not pledged, assigned, hypothecated or transferred the title to any of its assets, except as noted on this form or on a supporting schedule, nor has any such action been taken since that date, except as follows (give details) ______

Legal Actions — No lawsuits, claims, judgments or other legal actions are outstanding or pending against the partnership or any partner and to the best of our knowledge no legal actions are to be started against the partnership or any partner, except as follows (give details) ________

Insurance Coverage — Fire Insurance: Inventory $ Buildings $ Machinery & Equipment $ ________, Furniture & Fixtures $ Indicate if policies have extended coverage endorsement: Use & Occupancy Insurance $________
Liability Insurance: Autos & Trucks $ General Public $____ Burglary Insurance $ ________, Fidelity Bonds $________
Other Insurance (describe) ________
Date of latest independent analysis of insurance: ________, Indicate adequacy of coverage ________

Ownership — List all General and Special Partners

Name (Designate General Partner, G.P. and Special Partner, S.P.)	Age	Capital Contributions	Current Annual Compensation from Partnership	Partners' Personal Financial Data			
				Date	Outside Net Worth	Debts Outside Firm, Including Mortgages	Liability as Co-maker, Guarantor, Endorser, etc.
		$	$		$	$	$

Our ________ (Written or Oral) Partnership Agreement went into effect on ________ (Date) and expires on ________ (Date). The responsibility of the Special Partners for the partnership's debts is limited to ________ until ________ (Date)

Affiliated Companies & Interests — Give names, extent of interest, and nature of interrelationship. ________

Accounting Data — Name of Independent Accountant ________, Indicate if Certified Public Accountant ________
Frequency of Independent Audits ________, Date of Latest Independent Audit ________
Date of Fiscal Year End ________, Date of Latest Physical Inventory ________

(Continued on Next Page)

changes have occurred in the size of items between the last two statement dates or in the relationships, or ratios, between important items.

"Information—ever more information" is the daily motto of the loaning official of every really efficient, progressive commercial banking institution.

Figure 31D Federal Reserve Bank of New York Long Statement Form for Partnerships (*page 4*)

—4—

OPERATING STATEMENT

FOR THE ______ MONTH PERIOD ENDED ______ 19__

Gross Sales—To Regular Customers		$	
—To Affiliates			$
Less Returns and Allowances (Do not deduct Cash Discounts)			
Net Sales			$
Cost of Sales			
Inventory at Beginning of Period	$		
Purchases (Do not deduct Cash Discounts)			
Direct Labor			
Depreciation & Amortization			
Other Costs (Itemize)			
		$	
Less Inventory at End of Period			
Gross Profit			$
Administrative and General Expenses (Schedule No 1)			
Selling Expenses (Schedule No 2)			
Net Operating Profit			$
Other Income (Schedule No 3)			
Other Expense (Schedule No 4)			
Net Profit for the Period			$

OPERATING STATEMENT SCHEDULES

No. 1—ADMINISTRATIVE & GENERAL EXPENSES:		No. 2—SELLING EXPENSES:	
Partners' Salaries	$	Salaries (Other than to Partners)	$
Other Salaries		Commissions	
Depreciation & Amortization		Traveling	
		Advertising	
Total	$	Total	$

No. 3—OTHER INCOME:		No. 4—OTHER EXPENSE:	
Cash Discounts on Purchases	$	Cash Discounts on Sales	$
		Interest	
		Bad Debts	
Total	$	Total	$

RECONCILIATION OF NET WORTH

FOR THE ______ MONTH PERIOD ENDED ______ 19__

Net Worth—Beginning of Period		$	Carried Forward		$
Additions to Net Worth (Itemize)			**Deductions from Net Worth** (Itemize)		
Net Profit for the Period	$		Partners' Withdrawals (Other than Salaries)	$	
Partners' Capital Contributions					
Forward		$	Net Worth—End of Period		$

Certification—This is to certify that the foregoing figures were taken from the books and records of this partnership and that they and all other statements on this form and on any supporting schedules are true and give a correct showing of the financial condition of the partnership as of the date indicated IN THE EVENT OF ANY MATERIAL ADVERSE CHANGE IN THE FINANCIAL CONDITION OF THIS PARTNERSHIP, WE AGREE TO NOTIFY THE FINANCIAL INSTITUTION NAMED HEREIN IMMEDIATELY IN WRITING.

Signed this ______ day of ______________ 19____

______________________ (Partnership Name)

By ______________ (Signature) ______, General Partner

NOTE When there is no written partnership agreement, all the partners should sign.

IMPORTANT: If an audit was made as of the date of this statement, a copy of the accountant's report should be submitted herewith.

chapter VII

INTERPRETATION OF THE BALANCE SHEET

SETH B HUNT WAS EMPLOYED AS A CLERK BY ARTHUR TAPPAN & Co in New York City from June 1830 to December 1835 By that time he had saved a little money and had learned much about the wholesale and retail silk goods business Late in 1835, when he had failed to come to mutually satisfactory arrangements with Arthur Tappan regarding his 1836 salary, Hunt decided to start in business on his own account

In 1869, writing of certain episodes in this early part of his business career, Hunt went on to narrate

> What was my surprise, one day, soon after my leaving him [Arthur Tappan], when he stood at my desk, looking earnestly at me and said, "I thought you might need a bank endorser and I came to say that we would go on your paper for twenty five thousand dollars" Before I had recovered from my surprise or had time to thank him, he was half way out of the store The custom then was for merchants to exchange paper to use at their banks[1]

In fact, this method of borrowing on what subsequently came to be known as "accommodation paper"[2] was one of the general procedures

[1] Lewis Tappan, *Life of Arthur Tappen* (New York Hurd & Houghton 1870) p 287

[2] In 1839 Condy Raguet had already explained that the discounting of accommodation paper was not a healthy banking practice He wrote, "But it is absolutely necessary upon sound banking principles, that no paper except that received for property sold should be discounted Fictitious or accommodation notes are not as safe investments for a bank as real notes A real note given by A to B, for five thousand dollars, for a hundred hogsheads of sugar sold and delivered endorsed by the latter, and discounted by a bank, is guaranteed by B, who has five thousand dollars in cash, the proceeds of the note, less the discount, and by A who has five thousand dollars worth of sugar Of this there is no doubt An accommodation note drawn by C to D may have upon it two names apparently as solvent, but there is

for obtaining credit from banking institutions over a period of many decades beginning early in the nineteenth century. This practice went out of existence in a broad way in the last quarter of the century.

In addition to extending credit on accommodation paper, banking institutions also granted credit against a variety of securities, such as unimproved government land immediately prior to the panic of 1837, against endorsed notes receivable and trade acceptances, and also at times on unendorsed notes.[3] Financial statements, either audited or signed, were virtually unknown. Credit was extended on the assumed financial strength of the maker and the endorser, which too often was as entirely mythical. In country districts, where money was invested largely in fixed property, farmlands, houses, farming equipment, improvements, and cattle, bank credit was extended more extensively on endorsed accommodation paper than in the cities, which were providing the headquarters for growing industrial and commercial establishments.

Several decades later James B. Forgan, while chairman of the board of The First National Bank of Chicago, succinctly described typical conditions in a town in which he had obtained some of his early banking experience.

> There were three banks in the town and practically all of their loans were made on notes having two endorsers. A great depression occurred in the prin-

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no certainty that the two together possess anything more than the sum loaned by the bank. And this is not all. The discounting of a real note is merely anticipating a capital previously existing, whereas the discounting of an accommodation note is lending capital to one who did not possess it before. The borrower of money on an accommodation note must require it to pay an old debt, in which case his control over it is parted with, or, for some new operation, agricultural, commercial, manufacturing, or speculative, which in the nature of things may not be terminated in a short time, and in neither case is he the sort of borrower that a bank can rely upon to enable it to meet, under all circumstances, its notes payable on demand. Nor is this yet all. The discounting of notes given for property sold, does not encourage over-trading, like the discounting of accommodation notes. The latter, if the proceeds be not applied to pay old debts, places at the disposal of borrowers the means of speculating which they did not before possess. Speculation raises prices, and stimulates speculative sales and transfers, by which the regular business of the community is disturbed, only to be followed by a reaction." *A Treatise on Currency and Banking* (2nd ed.; Philadelphia: Griff & Elliot, 1839), pp. 92–3.

[3] Harry E. Miller, in *Banking Theories in the United States Before 1860* (Cambridge: Harvard University Press, 1927), p. 97, gives as a classic example the case of the Farmers' Exchange Bank, of Gloucester, R. I., which failed in 1809 with $86.50 in specie in its vaults, after having loaned $845,771 on the basis of $100,000 capital, upon unendorsed notes reading: "I, Andrew Dexter, Junr., do promise the President, Directors, and Co. of the Farmers' Exchange Bank, to pay them, or order, ... dollars in ... years, from this date, with interest at two per cent per annum; it being, however, understood that the said Dexter shall not be called upon to make payment until he thinks proper, he being the principal Stockholder and best knowing when it will be proper to pay the same."

cipal industry of the locality and a very considerable liquidation of bank credits became necessary The banks soon found, however, that the money they had thus loaned had been largely invested in fixed property and that their notes were of anything but a liquid character The banks in many cases refused to renew the notes and they lay past due They began to bring pressure on the makers and endorsers alike but soon awoke to the fact that all of their borrowing customers were so involved as endorsers for each other that they resembled a row of bricks standing on end so that if one were knocked down it would fall on another until all were laid low [4]

EVOLUTION OF UNSECURED LOANS

This early practice by banking institutions of extending credit against security and against two name accommodation and trade paper continued up to the decade beginning with 1870 During this decade loans were first made on single name paper as a matter of sound banking and business policy Although initially considered a most hazardous experiment, the practice spread until by 1900 it had become the customary basis for commercial and industrial loans with both city and country banks

The practice of granting unsecured loans on single name paper, which today is such an ingrained part of our established American banking routine, arose from one of the real economic consequences of the Civil War, the depreciation of our currency, and the result has persisted over the years We went through no such stirring currency inflation period as did Italy, France, or Germany following World War I, or as did the original thirteen colonies during the Revolutionary War, when "a wagon load of money would scarcely purchase a wagon load of provisions" From 1862, however, when United States notes were forced into circulation, until 1879, when specie payment was finally resumed, wholesale and retail transactions, the purchase of raw material by manufacturing plants, the payment of wages and rents, insurance premiums and policies were made in a fluctuating unit of monetary value We are going through a similar period today

At one time during the Civil War, the current value of paper money dropped to thirty-five cents on the gold dollar These constant daily fluctuations in the unit of everyday currency naturally made the extension of credit by banks and mercantile houses precarious In Germany the mark rapidly went to pieces and was succeeded in October 1923 by the Rentenmark at the unheard of ratio of 1 to 1,000 000,000,000 [5] Following the

[4] James B Forgan Evolution in Banking Thought During the Past Generation," *Bulletin of the National Association of Credit Men* XIX, No 10, October 1917 pp 935–6

[5] Erik Achorn *European Civilization and Politics Since 1815* (New York Harcourt, Brace & Co 1934), p 565

Civil War in our own history, the changing daily value of greenbacks in terms of gold reversed the almost universal example of depreciating toward an inflated zero as a mathematical limit, and in President Hayes's administration a paper dollar again was worth and exchangeable for one gold dollar. While greenbacks were fluctuating below par during and immediately after the Civil War, however, wholesale merchants were naturally unwilling to sell a bill of goods on six-month terms, out of fear that the greenbacks with which they would be paid would be worth less than at the time of the sale. Uncertainty and apprehension were almost nationwide in commercial circles.

So we find eastern wholesale merchants at this period in our westward expansion shortening their terms of sale to thirty days, and in many cases to ten. In addition, these merchants offered a premium in the form of a cash discount for early payment, instead of requiring, as previously, payment by note or trade acceptance. This shift in established business practice was facilitated by the growth in the means of communication and transportation. Buyers could now come to market several times each year or order by mail or from samples carried by salesmen, instead of ordering once or twice each year. Simultaneously our banking system developed to keep pace with the expanding needs of local businesses.

This simple, but expedient, shortening in the terms of sale brought about an equally revolutionary change in banking practice. It was under these circumstances that James Buell, president of the Importers and Traders National Bank of New York City, proceeded in the eighteen-seventies to show his depositors the distinct advantage of borrowing funds upon their own credit and using these funds to discount trade purchases. Nothing could be more simple or logical. Bankers, however, were reluctant to follow Buell's example, as they lacked the credit experience, the background in gathering essential credit data—in fact, what we now believe are essential data could not then have been obtained—and the ability to draw independent logical deductions on credit risks. To these bankers it appeared safer to extend credit on two-name paper, even though little or no exact information was available regarding the actual financial responsibility of either name.

DEVELOPMENT OF ACCOUNTANCY

That is not the whole story, for it was difficult to obtain essential financial information even when a depositor was willing to co-operate fully in turning over his books to the banker for careful perusal. Few enterprises at this period in our economic history had reliable figures covering their

operations even for their own use. Accountancy in the United States was in its childhood and was just beginning to make some feeble effort toward becoming a profession. If a banker had requested a businessman to have his books audited by an accountant, the businessman would innocently and naively have asked "What is an accountant?" Our business life at this time was characterized by an entire lack of restraint and by intense orthodox competition—not by mass production, rapid transportation, national advertising, or accountancy.

This change in banking practice involved a gradual change in perspective and outlook and in banking forms, technique, and knowledge. Skepticism of a new principle is always followed by toleration, and toleration by extension of the practice. In this case the change during the last quarter of the nineteenth century brought about appreciation of the need for exact data regarding the individual financial responsibility of business enterprises and for training to interpret those figures in order to obtain the maximum amount of pertinent information. By the turn of the century the extension of loans on single name paper had become a recognized practice of American commercial banking institutions, a practice unique among the banking systems of the world.

When President Buell of the Importers and Traders National Bank was showing the partners of mercantile houses in New York City the profitableness of adjusting business policies to changing times, strange as it may seem, there was not a single public accounting firm in the United States to assist this development.

In 1883 Edwin Guthrie, a receiver for a bankrupt English financial organization, visited the United States to ascertain the value of certain assets the bankrupt enterprise owned here. On arrival, Guthrie was unable to find a public accounting firm to assist him in his investigation.[6] He became acquainted with John Wylie Barrow, an actuary employed by the New York branches of certain British fire insurance companies, and out of this acquaintance grew the first accounting firm[7] on this side of the Atlantic. In October 1886 James T. Anyon sailed from England to become a senior assistant in the firm, and in the following year he became a partner.

[6] For information regarding early accountants, see Norman E. Webster, 'Public Accountancy in the United States,' *The American Institute of Accountants, Fiftieth Anniversary Celebration Volume*, 1937 (American Institute of Accountants, New York, 1938), pp. 104-108. See also A. C. Littleton, "Directory of Early American Public Accountants," *University of Illinois Bulletin*, XL, No. 8, October 13, 1942.

[7] Barrow, Wade, Guthrie & Co., which in 1950 merged into the firm of Peat, Marwick, Mitchell & Co.

Meanwhile, a few accounting firms had been organized. Accountancy had no specialized field and was considered in the nature of a bookkeeping job, particularly concerned with straightening out mixed-up books.[8] The general public referred to accountants as "experts" or "expert accountants" or sometimes simply as "checkers." A typical advertisement read: "John Doe, Expert Accountant, Books written up and balanced, Tangled-Accountants straightened out." Businessmen generally did not take kindly to these new "experts," who were considered little more than ambitious bookkeepers. When any accounting problem came up for consideration, the typical business executive would often go to his lawyer or, better still, as it cost less money, to his banker and obtain the services of one of the bank clerks. "Just as the general public was not particularly impressed with these experts, so bankers on their part had very little or no use for their services, while lawyers looked upon them more in the light of trespassers on their own business preserves than anything else, for lawyers in those times did or rather tried to do any special work in ac-

[8] "It is true," wrote Anyon in describing the difficulties that the accounting profession had in getting established, "that some business men had a fairly good conception of the character of the profession, and saw advantages in it which when better understood would undoubtedly be a benefit to business at large. On the contrary there were a great many who had very mixed ideas as to just what the business of the expert accountant was, and exactly what he professed to do. Some considered that he was an experienced bookkeeper and no more, others looked upon him as a man whose business it was to detect fraud, embezzlement and stealing, and that his employment was of value only in this direction, while quite a few had a vague idea that he was merely a man of figures, a rapid and unerring calculator who could add up two or three columns of figures at a time, could tell you immediately the square or cube root of any given number or say off-hand for example what one dollar put out at six per cent compound interest per annum at the time Columbus discovered America would amount to today. I will give you an example of this type. A lady called at my office one day and announced that she wished to see me on an important business matter. The lady in question proved to be the late Mrs. Hetty Green, whom many will remember as being a rather picturesque figure in this city some years ago. She entered the office and after scrutinizing me fully and carefully said, 'I understand from Mr. Williams of the Chemical National Bank that you are an expert calculator and figurer, and can decipher accounts that are wrong.' I hastened to assure her that I was not a particularly quick or expert calculator, that I was an accountant. 'Well,' she replied, 'I suppose it's the same thing and I'll tell you what I want,' and thereupon set out in a voluble and business-like way to state her case. She was the residuary legatee under a certain will in a large estate and was much dissatisfied with the acts and doings of the executors and trustees of said estate and desired to know if I was sufficient of an expert 'figurer' or calculator to find out and lay bare these wrongful acts. I informed her that as an accountant I felt I could do this fully and satisfactorily, but that it was not essential I should be an expert figurer and calculator to do the work properly. This did not seem to satisfy the lady who evidently considered I had failed to prove my case and that by my own showing I was not a fit and proper person to take up her matter for I did not get the work." James T. Anyon, *Recollections of the Early Days of American Accountancy* (privately printed, 1925), pp. 41–2.

counting matters that now falls to members of the accounting profession'[9] Over the years many things have changed!

At this stage in its development, accountancy was about as far advanced as the automobile industry when Henry Ford rode in his first two-cylinder car in 1893 Today, universities, colleges, and business schools have courses of study in bookkeeping, accountancy, auditing, corporation finance, credits, and the interpretation of financial statements, and high schools offer extensive bookkeeping courses According to regulations of the Securities and Exchange Commission, every corporation with securities listed on a national exchange and every corporation that offers a new issue of securities amounting to more than $300,000 to the public must have its figures audited by an 'independent" public accountant or firm of accountants[10]

Tremendous progress has been made in keeping accurate records of the earnings and financial condition of business enterprises since Edwin Guthrie made his exploratory visit to New York City in 1883 Typewriters have succeeded the flourishing penman, looseleaf ledgers have replaced the early leather-bound volumes, and electrical data-processing machines, the human calculator This progress, in turn, has provided a fundamental basis for the rapid growth, since the turn of the century, in the number of corporations with distributed stock interests It would have been too much to expect the public to invest in the securities of such widespread corporations as American Telephone and Telegraph, General Motors, and United States Steel if accountancy had not been developed to this point by independent public accountants

[9] *Ibid.*, pp 38–9

[10] *Rule 2-01 Qualifications of Accountants* "(*a*) The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of the place of his residence or principal office The Commission will not recognize any person as a public accountant who is not *in good standing and entitled* to practice as such under the *laws* of the *place of his* residence or principal office (*b*) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent For example an accountant will be considered not independent with respect to any person (i.e., business) or any of its parents or subsidiaries in whom he has, or had during the period of the report any financial interest, or any material indirect, financial interest or with whom he is or was during such period connected as a promoter, underwriter, voting trustee director, officer, or employee (*c*) In determining whether an accountant may in fact be not independent with respect to a particular person (i e., business), the Commission will give appropriate consideration to all relevant circumstances including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission" Regulation S-X (Washington D C Securities and Exchange Commission Nov 1, 1958), p 2

Figure 32A Statement Form for Corporations Designed and Approved by the Bank Management Commission of the American Bankers Association (*page 1*)

FORM NO. 3

CORPORATION
FINANCIAL STATEMENT
(LONG FORM)

FORM DESIGNED AND APPROVED BY
BANK MANAGEMENT COMMISSION
AMERICAN BANKERS ASSOCIATION

NAME__________ __________ (DATE)

BUSINESS__________ ADDRESS__________

TO__________ (NAME OF BANK)

FOR THE PURPOSE OF OBTAINING ADVANCES FROM TIME TO TIME ON BILLS, NOTES AND OTHER COMMERCIAL PAPER SIGNED OR ENDORSED BY THE UNDERSIGNED AND OF OBTAINING CREDIT GENERALLY THE UNDERSIGNED MAKES THE FOLLOWING STATEMENT OF______FINANCIAL CONDITION AS OF THE CLOSE OF BUSINESS ON THE____DAY OF________19__, AND CERTIFIES TO THE ABOVE-NAMED BANK THAT THE INFORMATION HEREINAFTER SET FORTH IS IN ALL RESPECTS TRUE, ACCURATE AND COMPLETE AND CORRECTLY REFLECTS THE FINANCIAL CONDITION OF THE UNDERSIGNED ON THE DATE AFOREMENTIONED

(FILL ALL BLANKS WRITING "NO" OR "NONE" WHERE NECESSARY TO COMPLETE INFORMATION)

ASSETS			
CASH—ON HAND \$____ IN BANK \$____ (SEE SCHEDULE)			
NOTES RECEIVABLE OF CUSTOMERS (SEE SCHEDULE)			
ACCOUNTS RECEIVABLE OF CUSTOMERS (SEE SCHEDULE)			
MERCHANDISE—FINISHED (SEE SCHEDULE)			
—IN PROCESS			
—RAW			
SECURITIES OWNED (OTHER THAN IN SUBSIDIARIES AND AFFILIATES) (SEE SCHEDULE)			
OTHER CURRENT ASSETS (ITEMIZE)			
TOTAL CURRENT ASSETS			
INVESTMENTS IN SUBSIDIARIES AND AFFILIATES (EXCLUDING LOANS, ADVANCES, ETC.) (SEE SCHEDULE)			
DUE FROM SUBSIDIARIES AND AFFILIATES (SEE SCHEDULE			
DUE FROM STOCKHOLDERS DIRECTORS, OFFICERS AND EMPLOYEES			
LIFE INSURANCE—CASH SURRENDER VALUE (DO NOT DEDUCT LOANS) (SEE SCHEDULE)			
GOODWILL, PATENTS, TRADEMARKS, COPYRIGHTS DIES, PATTERNS ETC			
LAND—USED IN BUSINESS (SEE SCHEDULE)			
BUILDINGS—USED IN BUSINESS } BEFORE DEPRECIATION RESERVES			
MACHINERY AND EQUIPMENT } BEFORE DEPRECIATION RESERVES			
FURNITURE AND FIXTURES } BEFORE DEPRECIATION RESERVES			
TRUCKS AUTOS HORSES, WAGONS ETC. } BEFORE DEPRECIATION RESERVES			
LAND AND BUILDINGS—NOT USED IN BUSINESS (SEE SCHEDULE)			
PREPAID EXPENSES—INTEREST INSURANCE, ETC.			
OTHER ASSETS (ITEMIZE)			
TOTAL			

LIABILITIES			
NOTES PAYABLE			
TO BANKS			
FOR MERCHANDISE			
FOR MACHINERY EQUIPMENT ETC			
TO OTHERS FOR BORROWED MONEY			
TRADE OR BANK ACCEPTANCES PAYABLE			
ACCOUNTS PAYABLE—NOT DUE			
—PAST DUE			
DUE TO SUBSIDIARIES AND AFFILIATES			
DUE TO STOCKHOLDERS DIRECTORS OFFICERS, AND EMPLOYEES			
DIVIDENDS DECLARED BUT UNPAID			
RESERVED FOR AND ACCRUED TAXES			
ACCRUED EXPENSES—WAGES INTEREST INSURANCE			
CHATTEL MORTGAGES } DUE WITHIN 1 YEAR			
MORTGAGES } DUE WITHIN 1 YEAR			
BONDED DEBT } DUE WITHIN 1 YEAR			
OTHER CURRENT LIABILITIES (ITEMIZE			
TOTAL CURRENT LIABILITIES			
CHATTEL MORTGAGES } DUE AFTER 1 YEAR			
MORTGAGES } DUE AFTER 1 YEAR			
BONDED DEBT (SEE SCHEDULE) } DUE AFTER 1 YEAR			
LOANS ON LIFE INSURANCE			
OTHER LIABILITIES (ITEMIZE)			
TOTAL LIABILITIES			
RESERVES FOR DEPRECIATION			
BUILDINGS			
MACHINERY AND EQUIPMENT			
FURNITURE AND FIXTURES			
TRUCKS, AUTOS ETC.			
RESERVE FOR CONTINGENCIES			
OTHER RESERVES (ITEMIZE)			
TOTAL RESERVES			
CAPITAL AND SURPLUS			
PREFERRED STOCK } (SEE SCHEDULE)			
COMMON STOCK } (SEE SCHEDULE)			
EARNED SURPLUS			
CAPITAL SURPLUS			
TOTAL			

(BE SURE ALL SCHEDULES ARE FILLED OUT)

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PREPARATIONS FOR ANALYSIS

Six steps must always be taken preparatory to analyzing the figures of a business enterprise. These steps are simple, rational, and deliberate attempts to determine what has been going on behind the scenes.

These six steps must be followed consciously or subconsciously in analyzing the figures showing the financial condition of a corner drug store with a tangible net worth of $6,000 or of a manufacturer of paints and varnishes with a tangible net worth of $10,000,000. In the first case the steps may be followed more rapidly, some steps may be skipped, and

Figure 32B Statement Form for Corporations (*page 2*)

CONTINGENT LIABILITIES

NOTES RECEIVABLE, TRADE ACCEPTANCES, OR DRAFTS DISCOUNTED OR SOLD		GUARANTOR FOR OTHERS ON NOTES, ACCOUNTS OR CONTRACTS	
NOTES RECEIVABLE OR TRADE ACCEPTANCES PLEDGED OR ASSIGNED		MAXIMUM LIABILITY FOR PROPOSED ADDITIONAL INCOME TAXES	
CUSTOMERS' ACCOUNTS DISCOUNTED OR SOLD		BONDS ON UNFINISHED CONTRACTS	
CUSTOMERS' ACCOUNTS ASSIGNED OR PLEDGED		PURCHASE COMMITMENTS OUTSTANDING	
ACCOMMODATION PAPER, ENDORSEMENTS OR NOTES EXCHANGED WITH OTHERS		LITIGATION IN PROCESS OR THREATENED	
		OTHER CONTINGENT LIABILITIES	

STATEMENT OF PROFIT AND LOSS

FOR THE PERIOD BEGINNING ______ 19__ AND ENDING ______ 19__

GROSS SALES
LESS: RETURNS AND ALLOWANCES
NET SALES
COST OF GOODS SOLD:
TOTAL INVENTORIES AT BEGINNING OF PERIOD
ADD: PURCHASES DURING PERIOD
[illegible] } DIRECT LABOR
DEPRECIATION
OTHER FACTORY OVERHEAD
TOTAL
DEDUCT TOTAL INVENTORIES AT CLOSE OF PERIOD
GROSS PROFIT
SELLING EXPENSES
SALARIES
COMMISSIONS
TRAVELING
ADVERTISING
TOTAL
ADMINISTRATIVE AND GENERAL EXPENSES
OFFICERS' SALARIES
OTHER SALARIES
RENT
NOTES AND ACCOUNTS CHARGED OFF
DEPRECIATION [illegible]
TOTAL

TOTAL ADMINISTRATIVE, GENERAL AND SELLING EXPENSES
OPERATING PROFIT
OTHER INCOME
INVESTMENTS
CASH DISCOUNTS RECEIVED
RECOVERIES FROM NOTES AND ACCOUNTS PREVIOUSLY CHARGED OFF
OTHER
TOTAL
OTHER EXPENSES
INTEREST
CASH DISCOUNTS GIVEN
OTHER
TOTAL
NET PROFIT OR LOSS BEFORE INCOME TAXES
ACCRUED FEDERAL INCOME TAXES
ACCRUED STATE INCOME TAXES
TOTAL
NET PROFIT OR LOSS CARRIED TO SURPLUS

AMOUNT OF DIVIDENDS DECLARED AND/OR PAID SINCE STATEMENT DATE ______ $______

RECONCILIATION OF EARNED SURPLUS
EARNED SURPLUS AT CLOSE OF PREVIOUS FISCAL YEAR
ADD: NET PROFITS [illegible]
OTHER ADDITIONS [illegible]
TOTAL ADDITIONS
LESS: DIVIDENDS PAID
CASH—PREFERRED, RATE ___%
—COMMON, RATE ___%
STOCK—PREFERRED ___ [illegible]
—COMMON ___ [illegible]
OTHER DEDUCTIONS [illegible]
TOTAL DEDUCTIONS
EARNED SURPLUS AT END OF PERIOD [illegible]

RECONCILIATION OF CAPITAL SURPLUS
CAPITAL SURPLUS AT CLOSE OF PREVIOUS FISCAL YEAR
ADDITIONS [illegible]
TOTAL ADDITIONS
DEDUCTIONS [illegible]
TOTAL DEDUCTIONS
CAPITAL SURPLUS AT END OF PERIOD [illegible]

WAS AN AUDIT MADE? ______ NAME OF INDEPENDENT ACCOUNTANT(S) ______
THE FISCAL PERIOD OF THIS CORPORATION CLOSES ON THE ______ DAY OF ______

BANK ACCOUNTS

NAME AND LOCATION OF BANKS	CASH BALANCE	CREDIT LINES	AMOUNT OF LOANS	ON WHAT BASIS (ENDORSEMENTS, UNSECURED, COLLATERAL, ETC.)
	$	$	$	

the answers may not be nearly so complicated, rarely leading into other problems, which must then be studied and restudied in order to make order out of apparent chaos. Nevertheless, all six steps must be taken in every case; they furnish the background without which no enlightened

Figure 32C Statement Form for Corporations (*page 3*)

NOTES AND TRADE ACCEPTANCES RECEIVABLE
—Customers Only (excluding those from affiliates)

NOT DUE			
RENEWED			
PAST DUE AND PROTESTED			
TOTAL NOTES AND TRADE ACCEPTANCES RECEIVABLE			
LESS RESERVE FOR DOUBTFUL			
NOTES AND TRADE ACCEPTANCES RECEIVABLE—NET			
AMOUNT CONSIDERED OF SLOW COLLECTION			
AMOUNT CONSIDERED OF DOUBTFUL COLLECTION			

ACCOUNTS RECEIVABLE
—Customers Only (excluding those from affiliates)

ACCOUNTS CHARGED WITHIN			
30 DAYS			
31 TO 60 DAYS			
61 TO 90 DAYS			
3 TO 6 MONTHS			
OVER 6 MONTHS			
TOTAL ACCOUNTS RECEIVABLE			
LESS RESERVE FOR DOUBTFUL ACCOUNTS			
ACCOUNTS RECEIVABLE—NET			
AMOUNT OF ACCOUNTS CONSIDERED DOUBTFUL			

SELLING TERMS ____

MERCHANDISE

MERCHANDISE ON HAND			
" CONSIGNED TO OTHERS			
" IN TRANSIT			
TOTAL			
LESS RESERVES (IF ANY)			
TOTAL AS PER STATEMENT			

1 AMOUNT OF MERCHANDISE PLEDGED ____
2. IS MERCHANDISE CONSIGNED TO YOU INCLUDED IN ASSETS? ____
3. AT WHAT TIME OF YEAR IS INVENTORY HIGHEST? ____ LOWEST? ____
4 AVERAGE AMOUNT OF INVENTORY ____
5 DOES INVENTORY REPRESENT PHYSICAL COUNT? ____ WHEN TAKEN? ____
6 DESCRIBE IN DETAIL THE BASIS OF VALUATION ____
7. STATE THE EXTENT OF ACCOUNTANTS VERIFICATION IF ANY ____
8 GIVE DATE (OR DATES) ON WHICH INVENTORY IS TAKEN AND BOOKS ARE CLOSED ____

SECURITIES OWNED

FACE VALUE (BONDS) NUMBER OF SHARES (STOCKS)	PER CENT OF TOTAL ISSUE	DESCRIPTION OF SECURITY	COST	PRESENT BOOK VALUE	MARKET VALUE	INCOME RECEIVED LAST YEAR	TO WHOM PLEDGED
			$	$	$	$	

ARE ALL SECURITIES OWNED REGISTERED IN THE NAME OF THE CORPORATION?

DUE FROM SUBSIDIARIES AND AFFILIATES

NAME OF CONCERN	LOCATION	FOR ADVANCES	WHEN DUE	FOR MERCHANDISE	TERMS
		$		$	

REAL ESTATE

	LOCATION AND DESCRIPTION	AGE	CONDITION	COST WITH IMPROVEMENTS	ASSESSED VALUE
1				$	$
2					
3					
4					
5					

	FIRE INSURANCE	ESTIMATED PRESENT VALUE	MORTGAGE		MORTGAGEE	USED IN BUSINESS?	YEARLY GROSS RENTAL INCOME
			AMOUNT	MATURITY			
1	$	$	$				$
2							
3							
4							
5							

THE LEGAL AND EQUITABLE TITLE TO ALL THE REAL ESTATE LISTED ABOVE IS SOLELY IN THE CORPORATION'S NAME, EXCEPT AS FOLLOWS ____

IF BOOK VALUE (BEFORE DEPRECIATION RESERVES) HAS DECREASED DURING THE YEAR, STATE REASON ____

LIFE INSURANCE

NAME OF PERSON INSURED	TYPE OF POLICY	FACE AMOUNT OF POLICY	TOTAL CASH SURRENDER VALUE	TOTAL LOANS AGAINST POLICY	TO WHOM POLICY IS ASSIGNED
		$	$	$	

analysis can be started Perhaps more erroneous conclusions have resulted from inadequate preliminary investigation than from any other single cause Preparation is no less essential in analyzing the financial responsibility of a business enterprise than in making plans to fly the Atlantic

Figure 32D Statement Form for Corporations (*page 4*)

BOND ISSUES (describe each issue separately)

DESCRIPTION OF ASSETS (INCLUDING CURRENT ASSETS, IF ANY) PLEDGED TO SECURE BOND ISSUES ____

SUMMARY OF INDENTURE PROVISIONS, INCLUDING SINKING FUND REQUIREMENTS ____

THERE ARE NO DEFAULTS IN CONNECTION WITH ANY OF THE PROVISIONS OF THE INDENTURE(S), EXCEPT AS FOLLOWS ____

NAME AND ADDRESS OF TRUSTEE(S) ____

CAPITAL STOCK

PREFERRED ____% PAR VALUE $____ CUMULATIVE? ____	SUMMARY OF PREFERRED STOCK PROVISIONS ____
AUTHORIZED $____	
UNISSUED $____	
OUTSTANDING $____	
COMMON PAR VALUE $____	VOTING POWERS OF PREFERRED STOCKHOLDERS ____
AUTHORIZED $____	
UNISSUED $____	
OUTSTANDING $____	AMOUNT OF PREFERRED STOCK DIVIDENDS ACCUMULATED AND UNPAID
COMMON NO PAR VALUE—SHARES OUTSTANDING ____	$____ REPRESENTING A PERIOD OF ____

LIABILITY INSURANCE (automobile, truck, general public liability, etc.)

NAME AND ADDRESS OF INSURANCE COMPANY	TYPE OF POLICY	AMOUNT OF COVERAGE: PERSONAL INJURY ETC.	AMOUNT OF COVERAGE: PROPERTY DAMAGE	EXPIRATION DATE
		$	$	

OTHER INSURANCE

KIND	CARRIED ON	[illegible]	AMOUNT	[illegible]
FIRE	MERCHANDISE			
	BUILDINGS			
	MACHINERY AND EQUIPMENT			
	FURNITURE AND FIXTURES			
	TRUCKS, AUTOS, WAGONS, ETC.			
CREDIT	ACCOUNTS AND NOTES RECEIVABLE			
USE AND OCCUPANCY				
FIDELITY BONDS				
OTHER				

OFFICERS

	NAMES IN FULL	NUMBER OF SHARES HELD: PREFERRED	NUMBER OF SHARES HELD: COMMON	ANNUAL COMPENSATION	ADDRESS
PRESIDENT				$	
VICE-PRES.					
VICE-PRES.					
SECRETARY					
TREASURER					

DIRECTORS

NAMES IN FULL	NUMBER OF SHARES HELD: PREFERRED	NUMBER OF SHARES HELD: COMMON	ANNUAL COMPENSATION	ADDRESS
			$	

IN SUBMITTING THE FOREGOING STATEMENT THE UNDERSIGNED GUARANTEES ITS ACCURACY WITH THE INTENT THAT IT BE RELIED UPON BY THE AFORESAID BANK IN EXTENDING CREDIT TO THE UNDERSIGNED AND WARRANTS THAT ____ HAS NOT KNOWINGLY WITHHELD ANY INFORMATION THAT MIGHT AFFECT ____ CREDIT RISK AND THE UNDERSIGNED EXPRESSLY AGREES TO NOTIFY IMMEDIATELY SAID BANK IN WRITING OF ANY MATERIAL CHANGE IN ____ FINANCIAL CONDITION WHETHER APPLICATION FOR FURTHER CREDIT IS MADE OR NOT AND IN THE ABSENCE OF SUCH WRITTEN NOTICE IT IS EXPRESSLY AGREED THAT SAID BANK IN GRANTING NEW OR CONTINUING CREDIT MAY RELY ON THIS STATEMENT AS HAVING THE SAME FORCE AND EFFECT AS IF DELIVERED UPON THE DATE ADDITIONAL CREDIT IS REQUESTED OR EXISTING CREDIT IS EXTENDED OR CONTINUED.

SIGNED AT ____

THIS ____ DAY OF ____ 19____

____
SIGNATURE OF CORPORATION

____
OFFICER

____
TITLE

Figure 33A Corporation Statement Form of the Chase Manhattan Bank, New York City (*page 1*)

(CORPORATION)

Name: ____________________

Address: ____________________ Business: ____________________

TO – The Chase Manhattan Bank:

For the purpose of procuring credit or any other financial accommodation from you from time to time, direct or contingent, the undersigned represents that the following is a true statement of the financial condition of the undersigned ON THE ____________ DAY OF ____________, 19____, and of all facts herein set forth, and for such purpose agrees that you may at any times hereafter assume that the condition and affairs of the undersigned have continued to be substantially as good as herein set forth and that there has been no change materially impairing the ability of the undersigned to pay all claims and demands against the undersigned, unless you shall have been notified in writing to the contrary by the undersigned, and for such purpose the undersigned further agrees to notify you immediately in writing of any substantial change in the condition or affairs of the undersigned. In consideration of your granting any such credit or other financial accommodation to the undersigned, direct or contingent, the undersigned agrees with you as follows: as security for the payment of all liabilities of the undersigned to you, direct or contingent, now existing or hereafter arising, you are hereby given a lien upon, and/or rights of set-off against, any deposit or other account of the undersigned with you, and all claims, money, stocks, bonds, commercial paper, instruments and other property of the undersigned which have or shall for any purpose come into your possession, custody or control, whether or not accepted for the purpose for which the same is delivered or intended. In any one or more of the following events, any and all obligations and liabilities of the undersigned to you, direct or contingent, now existing or hereafter arising, shall thereupon, unless you shall otherwise elect, become and be due and payable forthwith without any demand or notice to the undersigned if it shall appear at any time that any of the statements herein contained is untrue, or if the undersigned fails to notify you of any material change in the condition or affairs of the undersigned as above agreed, or if any change occurs in the condition or affairs of the undersigned which materially impairs the ability of the undersigned to pay all claims and demands against the undersigned, or if the undersigned assigns any accounts or transfers or encumbers any assets so as, in your opinion, to materially affect the business or financial condition of the undersigned; or if the undersigned (being an individual) shall die or (being a partnership or corporation) shall be dissolved, or if the undersigned shall become insolvent (however such insolvency may be evidenced), or make a general assignment for the benefit of creditors, or suspend the transaction of his, their or its usual business, or fail to pay any obligation to you when the same becomes due; or if a petition in bankruptcy, or a petition or application for composition, extension or reorganization shall be filed by or against the undersigned, or if any judgment or writ or warrant of attachment shall be entered or issued against the undersigned, or if a receiver shall be appointed of any of the property of the undersigned. No delay on your part in exercising any power or right hereunder shall operate as a waiver thereof, nor shall any single or partial exercise of any power or right hereunder preclude other or further exercise thereof or the exercise of any other power or right.

FILL ALL BLANKS WRITING "NO" OR "NONE" WHERE NECESSARY

ASSETS				
CURRENT:				
Cash on hand and in banks				
U. S. Government Securities				
Due from customers (for merchandise sold):				
Notes and Acceptances				
Open Accounts (less Reserves) (show details on Page 2)				
Due from controlled or affiliated concerns for current merchandise transactions only				
Merchandise: (show details on Page 2)				
Finished				
In process				
Raw				
Other (itemize)				
Total Current				
FIXED:				
Land and Buildings used in operations: (how valued?)				
(list mortgages, if any, in liabilities)				
Machinery, Equipment and Fixtures				
Investments: (show details on Page 2)				
Controlled or Affiliated Concerns				
Other Bonds or Stocks				
Cash Surrender Value Life Insurance				
Land and Buildings not used in operations				
Other (itemize)				
Total Fixed				
DEFERRED AND MISCELLANEOUS:				
Miscellaneous Materials, Supplies, etc.				
Prepaid Expenses—Interest, Insurance, etc.				
Advances to controlled or affiliated concerns for other than current merchandise items				
Due from stockholders, directors, officers, and employees				
Treasury Stock (do not include unissued stock)				
Goodwill, Patents, Bond Discount, etc.				
Other (itemize)				
TOTAL				

LIABILITIES AND CAPITAL				
CURRENT: (due within one year).				
Notes Payable: To Banks { Secured				
{ Unsecured				
Notes sold through brokers				
To others for borrowed money				
Notes or Acceptances Payable—Trade				
Acceptances under Letters of Credit				
Accounts Payable:				
For merchandise				
Other				
Due to controlled or affiliated concerns				
Due to directors, officers, and employees				
Deposits (when payable?)				
Accrued Expenses				
Reserve for Federal Taxes				
Mortgages, Bonds, Long Term Notes (due within a year)				
Other (itemize)				
Total Current				
DEFERRED: (due after one year)				
Mortgage Debt (give particulars)				
Bonded Debt (give particulars)				
Long Term Notes (when due?)				
Reserve for contingencies				
Reserve for depreciation				
Other (itemize)				
Total Liabilities				
NET WORTH:				
Capital Stock:				
Preferred ___% (Cum. or Non-Cum.?)				
Common: Par Value per share $ ___				
No Par Value (shares ______)				
Surplus (earned)				
Surplus (capital or paid in)				
NET WORTH				
TOTAL				

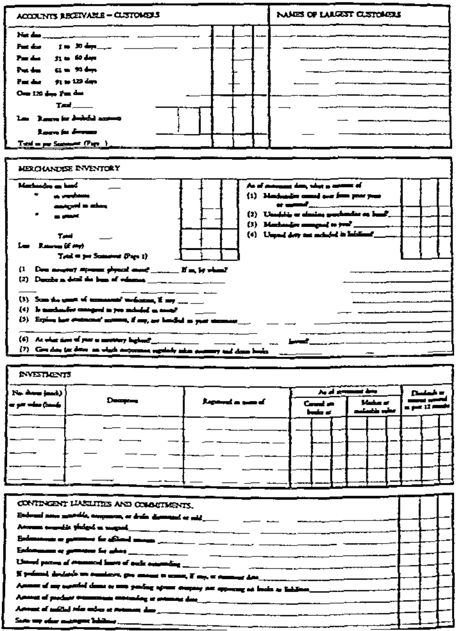
Have you any subsidiary or controlled companies? ______ If so, is above a consolidated statement? ______

(OVER)

Antecedent Information

The first step, already outlined in the preceding chapter, is to obtain a definite and complete picture, with no gaps in the antecedents, of the business record of each member of the operating staff, and a full history of the business concern itself

Figure 33B Corporation Statement Form of the Chase Manhattan Bank, New York City (*page 2*)



If the president of a corporation has had two fraudulent failures "to his credit" within the past five years, paying ten cents on the dollar in one and fifteen cents in the other, and in addition has had two questionable fires, an approach to the analysis of the figures of that business would be somewhat different than if the president had a clear record and every

Figure 33C Corporation Statement Form of the Chase Manhattan Bank, New York City (*page 3*)

PROFIT AND LOSS ACCOUNT: for ____ months ended ________ 19__

Gross Sales	
Less: Returns, Allowances and Discounts	
Net Sales	
Less: Cost of Sales	
Gross Profit on Sales	
Less: Officers Salaries	
Other General and Administrative Expenses	
Selling Expenses	
Net Operating Profit	
Other Income: Interest and Dividends	
Miscellaneous	
Gross Income	
Less: Interest	
Bad Debts	
Depreciation	
Reserve for Federal Taxes	
Miscellaneous	
Net Profit before Dividends	
Less: Dividends:	
Cash—Preferred, rate ___%	
—Common, " ___%	
Stock—Common or Preferred ___ rate ___%	
Amount carried to Surplus	
Surplus Adjustments:	
Additions:	
Total	
Deductions:	
Net increase or decrease in surplus for the above period	
Surplus period beginning (including paid in or capital surplus)	
Surplus period ending (including paid in or capital surplus)	

INSURANCE:

Form	Carried on	Beneficiary	Assignee	Amount
Fire........	Merchandise			
Fire........	Buildings and Equipment			
Credit......	Accounts and Notes Receivable			
Life........	Endorsers, Executives, etc.			
Other Kinds				

BANK ACCOUNTS:

Names of Banks	Credit Lines Arranged	Amounts in use at statement date	On what Basis (endorsements, receivables, collateral, etc.)

(OVER)

concern with which he had been associated during his entire business career had been successful. Fraudulent failures and fraudulent fires take place almost every day in the year. Although conclusive information is not available regarding the proximate cause in every case, the circum-

Figure 33D Corporation Statement Form of the Chase Manhattan Bank, New York City (*page 4*)

TRADE REFERENCES:

Name of Largest Creditors	Address	Amount owing at statement date

GENERAL INFORMATION

Maximum total current liabilities last year $ ______ Date ______

Minimum total current liabilities last year $ ______ Date ______

Are branches or controlled companies financed entirely by you? ______

If not, how do they borrow? ______ Give amount outstanding at statement date ______

Are their loans included in this statement? ______

To what extent do officers of corporation endorse or guarantee obligations for other concerns or individuals? ______

______

Give amount of loans, if any, against cash surrender value of life insurance ______

To what extent, if any, have you pledged any assets during past year? ______

______

Were any of the assets pledged at statement date? ______ If so, give details ______

______

What are your customary terms of sale? ______ of purchase? ______

Do you employ Certified Public Accountant(s) to audit your books regularly? ______

Were books audited by Certified Public Accountant(s) at statement date? ______ If so, please have certificate below signed ______

PLEASE SEND COPY OF ACCOUNTANTS' REPORT WITH THIS FORM

Please sign here (Corporate Name) ______

Date Signed ______ by ______
(Title of officer)

I/we have audited the accounts of ______ for the period from ______ to ______ and certify that in my/our opinion the above Balance Sheet and Profit and Loss Statement truly set forth the financial condition of the corporation at ______ and the results of its operations for the period, subject to the following qualifications:

______
Date signed

______
Certified Public Accountant(s)

1C8 23

stantial indications in many are clearly recorded in the files of fire insurance companies and commercial agencies maintained to protect legitimate business. There is nothing of theory here. The steps leading up to a fraudulent failure, the organization of the business, the prompt payment for initial purchases, followed by the surge of inquiries and larger pur-

Figure 34A Personal Statement Form for Individual Borrowers of the Mellon National Bank and Trust Company, Pittsburgh, Pa. (*front*)

PERSONAL STATEMENT (Confidential)

To MELLON NATIONAL BANK AND TRUST COMPANY

Name__________ Address__________

For the purpose of procuring and maintaining credit with Mellon National Bank and Trust Company, the undersigned submits this information and warrants it to be a true and accurate statement of its financial condition on the date here below written The undersigned further agrees that if any change occurs which would materially lessen its means or ability to pay all claims or demands against it, the undersigned will immediately and without delay notify the said Bank of such change in its financial condition, and until such notification has been received, the Bank may continue to rely upon the information herein given as a true and accurate statement of the financial condition of the undersigned

FINANCIAL INFORMATION FURNISHED AS OF CLOSE OF BUSINESS (Month)________(Day)_____19___

ASSETS				LIABILITIES			
Cash on hand and in Banks				*Notes payable to Banks*			
U S Gov Securities—see schedule				Secured			
Listed Securities—see schedule				Unsecured			
Unlisted Securities—see schedule				Notes payable to relatives			
Accounts and Notes Receivable				Notes payable to others			
Due from relatives and friends				Accounts and bills due			
Accounts and Notes Receivable				Accrued taxes and interest			
Due from others—good				Other unpaid taxes			
Accounts and Notes Receivable Doubtful				Mortgages payable on Real Estate—see schedule			
Real Estate owned—see schedule				Chattel Mortgages and other Liens payable			
Real Estate Mortgages owned							
Automobiles				Other debts—itemize			
Personal property							
C.S.V. of Life Insurance							
Other assets - itemize							
				TOTAL LIABILITIES			
				NET WORTH			
TOTAL ASSETS				TOTAL LIAB AND NET WORTH			

SOURCE OF INCOME		PERSONAL INFORMATION	
Salary	$	Business or Occupation	Age
Bonus and commissions	$		
Dividends and interest	$	*Partner or officer in any other venture*	
Real Estate income	$		
Other income—itemize	$	Married	Children
		Single	Dependents
TOTAL	$		

CONTINGENT LIABILITIES		GENERAL INFORMATION
As endorser or comaker	$	Are any assets pledged?
On leases or contracts	$	Are you defendant in any suits or legal actions?
Legal claims	$	
Provision for Federal Income Tax claim	$	Are there any judgments unsatisfied against you?
Other special debt	$	Have you ever been through bankruptcy or made settlement with creditors?

(SCHEDULES ON REVERSE SIDE)

LEAVE NO BLANK SPACES INSERT WORD "NONE" IN ABSENCE OF ANY AMOUNT

CR 7 REV 1/[illegible]

chases, the disappearance of the principals, are planned months ahead by the business moron who matches his efforts against the knowledge of the experienced credit man and the perseverance of the Federal mail investigating service[11]

Figure 34B Personal Statement Form for Individual Borrowers of the Mellon National Bank and Trust Company, Pittsburgh, Pa (*reverse*)

MELLON NATIONAL BANK AND TRUST COMPANY

LEAVE NO BLANK SPACES. INSERT WORD "NONE" IN ABSENCE OF ANY AMOUNT

SCHEDULE OF U S GOVERNMENTS STOCKS AND BONDS OWNED

DESCRIPTION	IN NAME OF	MARKET VALUE	IF PLEDGED STATE WHERE

SCHEDULE OF MORTGAGES OWNED

DESCRIPTION OF PROPERTY COVERED	DATE OF ACQUISITION	IN NAME OF	MATURITY	AMOUNT

SCHEDULE OF REAL ESTATE OWNED

DESCRIPTION AND LOCATION OF PROPERTY AND IMPROVEMENTS	DATE OF ACQUISITION	TITLE IN NAME OF	APPRAISED VALUE	MORTGAGE			TAXES PAID TO
				AMOUNT	MATURITY	INSURANCE	

SCHEDULE OF LIFE INSURANCE CARRIED

AMOUNT	NAME OF COMPANY	BENEFICIARY	CASH SURRENDER VALUE	LOANS

LIST BANKS FINANCE COMPANIES AND OTHER REFERENCES WHERE CREDIT HAS BEEN OBTAINED

NAME AND LOCATION	HIGH CREDIT	BASIS	OWE	PAST DUE

LIST OTHER BANKS WITH WHICH YOU HAVE ACCOUNTS

NAME OF BANK	NAME OF BANK

The undersigned certifies that both sides hereof and the information inserted hereon has been carefully read and is true and correct.

____________ 19____ Date.

____________ Signature.

[11] Studies of fraudulent failures appear in a pamphlet, *Signs of the Times*, and of fraudulent fires in *Relativity of the Moral Hazard*, both by Roy A Foulke (New York Dun & Bradstreet, Inc., 1938 and 1940 respectively)

Figure 35A Statement Form of the National Credit Office, Inc. *(front)*

FINANCIAL STATEMENT SUBMITTED TO NATIONAL CREDIT OFFICE, INC

Name ______ Business ______

Street and No ______ City ______ Zone ____ State ______

Owner—Partners—Officers and Directors	Title	% Ownership	In charge of

STATEMENT OF (DATE) 195

ASSETS		LIABILITIES	
CASH IN BANK $		ACCOUNTS PAYABLE	$
ON HAND $	$	DUE TO CONTRACTORS (without offset)	
U S GOVERNMENT SECURITIES		UNSECURED LOANS PAYABLE To Banks	
RECEIVABLES for Mdse Sold to Customers (Age on opposite page) ACCOUNTS $		To Partners or Officers	
Less Res for Discounts $		To Others	
Less Res. for Doubtful $		SECURED LOANS PAYABLE Owing to	
NOTES & TRADE ACCEPTANCES		ACCRUED WAGES & EXPENSES	
(Less $ ______ discounted)		TAXES—Accrued and Payable a Withholding & Payroll	
DUE from FACTOR or FINANCE CO		b Federal & State Income	
		c All Other	
PHYSICAL INVENTORY OF MDSE. (Valued at lower of Cost or Market)		RESERVE for Income Taxes since last closing	
Raw Materials $		MORTGAGE—DEFERRED DEBT—Due within 12 mos	
In Process $		**CURRENT LIABILITIES**	
Finished Mdse $			
		MORTGAGE—DEFERRED DEBT—Due after 12 mos	
CURRENT ASSETS		LOANS Subordinated until ______ (date)	
Due from Partners Officers or Employees			
Due from Affiliated or Assoc Companies		**TOTAL LIABILITIES**	
LAND & BUILDINGS $		IF CORPORATION	
Less Depreciation $		Capital Stock Pfd $	
MCHY EQUIP, FURN & FIXT $		Capital Stock Common $	
Less Depreciation $		Capital Surplus $	
INVESTMENTS (Describe on opp page)		Earned Surplus $	
PREPAID & DEFERRED		Deficit (red) $	
		CORPORATE PARTNERSHIP, or INDIVIDUAL ______ **NET WORTH**	
TOTAL ASSETS		**TOTAL LIABILITIES & CAPITAL**	

DEPOSITORY BANKS ______

INSURANCE—Fire Mdse $ ______ Bldg. & Fixt $ ______

Use & Occup $ ______, Burglary $ ______, Life, Benefit

Business $ ______ on ______

ACCOUNTANT — Was above statement prepared by an outside accountant? Yes ☐ No ☐ Is he C P.A.? ☐ Registered? ☐ Licensed? ☐

Accountant s Name ______

Address ______

On what date are your books closed? ______

LIST PRINCIPAL SUPPLIERS ON REVERSE SIDE

Figure 35B Statement Form of the National Credit Office, Inc (*reverse*)

PROFIT AND LOSS STATEMENT

FOR PERIOD FROM ________195____ TO ________195____

GROSS SALES ________ $________

Less RETURNS____$________

Less DISCOUNTS $________ $________

NET INCOME FROM SALES________ $________

Inventory—beginning $________

Purchases—Net ____$________

Labor ________$________

Factory Overhead ____$________

Total $________

Inventory at end ____$________

Cost of Goods Sold ________ $________

GROSS PROFIT ON SALES________ $________

Selling & Ship Exp $________

Salaries—Officers or Principals ____ $________

Adm & Gen Exp ____$________

Bad Debts ____ $________

Depreciation ____$________ $________

INCOME or (LOSS) ON SALES____ $________

Other Income (exclude discount earned) $________

Total $________

Deductions from Income ________ $________

NET PROFIT or (LOSS) before Income Taxes ________ $________

Provision for Fed & State Income Taxes $________

NET PROFIT or (LOSS) ________ $________

RECONCILIATION OF SURPLUS OR NET WORTH

Beginning (date) ________ $________

ADD

Profit for Period ____$________

Other Credits to Surplus ____$________ $________

Total $________

DEDUCT

Loss for Period ____$________

Div & W'thdr'ls ____$________

Other Charges to Surplus ____$________ $________

NET WORTH or SURPLUS at end________ $________

EXPLANATION OF ASSETS AND LIABILITIES

RECEIVABLES

For goods shipped during months of

a ________ $________

b ________ $________

c ________ $________

d Prior Months________ $________

Do these include any consigned goods, uncredited returns, or unshipped merchandise?________

Have all bad accounts been charged off or reserved?________

During the past year have you sold, pledged or assigned any receivables?________ If so name financing concern and describe transaction ________

Unfilled orders on hand________ (date) $________

MERCHANDISE

If not valued at Lower of Cost or Market state basis used ________

Is original inventory record retained by you ☐ or outside auditor ☐

Is any merchandise pledged as security for any debt?

If so state amount so pledged $________

Merchandise Purchase Commitments as of ________ (date) $________

INVESTMENTS—Describe

a ________ $________

b ________ $________

(If in subsidiary or affiliated concerns state % owned)

LIABILITIES

Merchandise received or charged to you but not included in Assets or Liabilities________ $________

Amount of Contingent Liabilities____ $________

Are any liabilities secured in any way?________ If so state amount creditor and nature of security________

Annual Rent $________ Lease Expires________

NET WORTH

Has this been decreased since statement date by withdrawal retirement of capital payment of dividends, bonuses, or personal Income Taxes?________

If so by what amount? $________

TAXES

Have all Federal State and Local tax assessments been paid or shown accrued on statement?________

Tax Closing date?________ Date of latest return examined by Internal Revenue Service?________

TO NATIONAL CREDIT OFFICE, INC
Two Park Avenue
New York 16, N Y

The undersigned warrants that the foregoing figures and answers are true and accurate in every respect and orders this statement mailed to you with the intention that it shall be relied upon in the extension of credit or insurance by such concerns, including factors or agents who may subscribe to your service now or hereafter My (Our) accountants are authorized to supply you with any supplementary information that may be required

Dated at________this____ ____day of________19____ ________ (Name of Corporation, Partnership or Proprietorship)

Signed in the presence of

Name________ By________

Address________ ________ (Signature of Officer Partner or Owner) (Title)

NATIONAL CREDIT OFFICE, INC. • TWO PARK AVE., NEW YORK 16, N. Y

A continuous record of each official in a business enterprise will indicate a high degree of moral responsibility or irresponsibility. The antecedent record of a newcomer to an enterprise under investigation will also indicate his experience or inexperience in this particular type of business.

Figure 36 Accountant's Supplementary Information Blank of the National Credit Office, Inc.

ACCOUNTANT'S SUPPLEMENTARY INFORMATION

Relating to the attached financial statement as of__________(date)

*Issued by*__________ *Address*__________

A. *Do the figures on this statement agree with the figures in your report: Yes__ No__*
Exceptions__________

B. Did you confirm the following items by direct correspondence:
1. Cash ________ Yes__ No__
2. Accounts Receivable ______ Yes__ No__
3. Customers Notes and Acceptances__ Yes__ No__
4. Due from Contractors__ Yes__ No__
5. Accounts Payable ____ Yes__ No__
6. Notes Payable ____ Yes__ No__
7. Due to Contractors__ Yes__ No__
8. Others (describe) __ Yes__ No__

Describe any other method used and relate to the item affected:__________

C. ACCOUNTS RECEIVABLE
1. Does aging agree with your report? Yes__ No__ If not, give aging below for merchandise shipped to customers:

Months	______	$______
of	______	$______
shipment:	______	$______
	Prior Months ______	$______
	Total	$______

2. In your opinion, is provision for bad debts adequate: Yes__ No__ If no opinion, explain:__________
3. In your opinion, is reserve for discounts adequate: Yes__ No__ If no opinion, explain:__________
4. To your knowledge, have any receivables been sold, pledged or assigned during the year immediately preceding the statement date: Yes__ No__
*If yes, explain:*__________
5. To your knowledge, do Accounts Receivable include any amounts due from subsidiary or affiliated concerns: Yes__ No__
Do Accounts Receivable include any individual accounts owing in excess of 25% of the net worth shown on attached financial statement: Yes__ No__
If yes, state amount $______ and number______

D. MERCHANDISE INVENTORY
1. Did you observe and test the count of the physical inventory quantities: Yes__ No__
If no, state how verified__________
2. If not verified, was detailed listing of inventory submitted to you: Yes__ No__ Is copy of original inventory listing in your possession: Yes__ No__
3. How was the inventory priced?__________
4. Did you test the inventory as to prices: Yes__ No__; Arithmetical Accuracy: Yes__ No__
5. *To your knowledge, has any merchandise been pledged as collateral during the year immediately preceding statement date: Yes__ No__*
If yes, explain:__________

E. INVESTMENTS — Describe__________

F. GENERAL
1. Are you a Certified Public Accountant: Yes__ No__ What State______ How often do you audit the books?______
2. Have all expenses and tax liabilities known to you been accrued: Yes__ No__
3. *Does the statement include all assets and liabilities known to you: Yes__ No__ Exceptions:*______
Explain__________
4. Do you know of any material contingent liabilities: Yes__ No__ Explain:______
5. Tax closing date:______ Last taxable year examined by Internal Revenue Service:______
6. If client is not incorporated, state amount you believe will be withdrawn for personal income taxes of principal or partners on income earned to statement date and not shown in statement: $______
7. Other comments, if any__________

TO NATIONAL CREDIT OFFICE, INC.

The above information is in answer to your inquiry regarding the attached financial statement of my/our client as of the date shown.

____
(Firm Name of Accountant)

____
(Signature of Individual Authorized to Sign)

Dated__________

ST 18-57 NATIONAL CREDIT OFFICE, INC. • TWO PARK AVE. NEW YORK 16, N. Y.

An individual who has operated a Turkish bath for ten years would hardly be expected to have a trained capacity for operating in the coat-and suit trade or running a Broadway nightclub Thousands of business liquidations occur each year because of the casual manner in which men enter into types of business operation for which their previous careers had given them little practical background

Method of Operation

The second step is to determine whether the concern is a manufacturer, wholesaler, importer, exporter, retailer, contractor, or commission merchant, and to obtain a clear conception of its operating methods The mark up on cost of goods sold by a representative wholesale grocer might be 12 per cent, and by a retail grocer, around 22 per cent The wholesaler might sell on thirty day terms, and the retailer, largely on cash terms These differences in the method of operation are naturally reflected in the figures In the case of the wholesaler, the size of the receivables would be quite important, but in the case of the retailer, there would be a small amount, if anything, in receivables

Preparatory to any analysis, the analyst, therefore, should know the terms of sale and credit, the class and number of accounts sold, the territory covered, and any variations from the typical method of operation If the terms of sale are unknown, there is absolutely no basis with which to compare the average collection period Again, if a manufacturer of men's shirts sell two thousand scattered retail accounts, the business might be less vulnerable than if the same volume of merchandise were sold to twenty-five mail-order houses and chain stores and a hundred larger department stores Furthermore, if the territory covered is not known, then there is no basis for rapid reasoning when calamities, such as hurricanes and floods, hit a territory

Names of all Subsidiary Corporations

The third step is to ascertain the names of all subsidiary and affiliated companies A chain is no stronger than its weakest link Weaknesses have often been concealed by loading poor business on weak subsidiaries and by offsetting gains against losses in consolidated statements

A subsidiary is nothing more or less than a corporation, the majority of whose voting stock is owned by another corporation Most of the larger industrial concerns have numerous subsidiaries, but the outstanding ex

ponent of this modern American financial, conspicuously legal, and far-flung economic instinct has been the typical public utility holding company.[12]

If a balance sheet bears such a heading as "General Motors Corporation *Condensed Consolidated Balance Sheet*" or "National Steel Corporation and Subsidiaries, *Consolidated Balance Sheet*," then the corporation obviously has subsidiaries. The words "consolidated balance sheet" mean that and nothing else. So, as soon as a consolidated balance sheet appears, a list of the names and addresses of all subsidiary units should be obtained, Whether there is only 1 subsidiary, or 101, makes no difference: that list should always be secured.

If a corporation has 101 subsidiaries, possibly the assets and the liabilities of only 50 have been consolidated, the interests of the parent company in the other 51 being carried among the assets in an "Investment" account. In this event the list of subsidiaries should be obtained in two divisions, the first containing the names and addresses of those subsidiaries whose assets and liabilities have been consolidated, and the other containing the names and addresses of those that have not been consolidated.

Even when the heading of the financial statement does not contain the words "consolidated balance sheet," the corporation may still have sub-

[12] Public utility holding companies, with their unusual and unique intercompany relations, came under the exacting regulations of the Public Utility Holding Company Act of 1935 and under the supervision of the Securities and Exchange Commission. This act became a Federal law on August 26, 1935. Section I(a) gave five reasons why "Public utility holding companies and their subsidiary companies are affected with a national public interest." Of these five reasons, two had to do with subsidiaries; these read: ". . . (1) their subsidiary public-utility companies often sell and transport gas and electric energy by the use of means and instrumentalities of interstate commerce," and (2) "their practices in respect of and control over subsidiary companies often materially affect the interstate commerce in which those companies engage. . . ." Section I(b) pointed out that "the national public interest, the interest of investors in the securities of holding companies and their subsidiary companies and affiliates, and the interest of consumers of electric energy and natural and manufactured gas, are or may be adversely affected," by five different sets of circumstances. Two of these sets of circumstances also concern subsidiary units indicating why the names of all subsidiaries should be obtained prior to the analysis of any figures: ". . . (1) when subsidiary public-utility companies are subjected to excessive charges for services, construction work, equipment, and materials, or enter into transactions in which evils result from an absence of arm's-length bargaining or from restraint of free and independent competition; when service, management, construction, and other contracts involve the allocation of charges among subsidiary public-utility companies in different States so as to present problems of regulations which cannot be dealt with effectively by the States; and (2) when control of subsidiary public-utility companies affects the accounting practices and rate, dividend, and other policies of such companies so as to complicate and obstruct State regulation of such companies, or when control of such companies is exerted through disproportionately small investment," then the interests mentioned in the first part of this paragraph may be adversely affected.

sidiaries In this case the heading is not self-explanatory The corporation may have one or ten subsidiaries and not consolidate their assets and liabilities, merely carrying the interests in these various units in the assets as an item of ' Investments " However, if a balance sheet does not contain in its heading the words consolidated balance sheet," and if the assets do not contain an item of ' Investments," then one may feel reasonably assured that the corporation has none of these modern appendages which more than anything else have tended to make the financial conditions and responsibilities of some corporations deep mysteries to the banker, the investor, the speculator, and the credit analyst. If there is an item of "Investments " the analyst must dig deeper in the manner outlined in the fifth step on page 197

When the list of subsidiaries is secured, every effort should be made to obtain their individual financial statements, which are as essential for a complete analysis as the consolidated statement. In complex corporate systems the subsidiaries, in turn, may have subsidiaries, children, grand children, and great-grandchildren, first cousins and second cousins. A chart of the corporate system will assist the analyst in ferreting out the essential data.

Individual figures of the parent company and of each subsidiary unit are invariably essential in examining thoroughly the credit soundness of any enterprise with various strata of underlying units Individual financial statements showing tie ups in stock interests and the amounts due to and from each other invariably are contained in complete audits made by accounting firms Since the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934, the names of these underlying units have been made available in registration statements and prospectuses not only to bankers but also to mercantile creditors investors, and the general public on practically every corporation that has offered its securities to the public The same information is available in the listing circulars that must be filed before listing privileges are granted by national security exchanges Only the names of subsidiaries however, are generally available—not their individual financial statements, and in many cases not even their addresses

Posting on Comparative Statement Sheet

The fourth step is to transpose the figures from the balance sheet, as received from the applicant for a loan, to an especially prepared comparative statement form Often it is necessary to combine several similar

items, such as "Due from Officers" and "Due from Employees," into one more general item, such as "Due from Officers and Employees" or "Miscellaneous Receivables." The practical objective is to take any balance sheet, no matter how lengthy or how complicated, and to combine similar items under five primary groupings: "Current Assets," "Other Assets,"

Figure 37A Comparative Statement Blank of Dun & Bradstreet, Inc. (*front*)

DUN & BRADSTREET, Inc
COMPARATIVE FINANCIAL STATEMENTS

TYPES OF FINANCIAL STATEMENTS	
Place appropriate Code designation X Y or Z at the top of each column in small box after statement date	CODE
Financial—Corporations without subsidiaries Proprietorship or Partnership	X
Individual—Corporations showing investment in subsidiary(s)	Y
Consolidated—Corporations and subsidiaries together	Z

NAME

STATEMENT DATE												
Cash												
Notes Receivable												
Accounts Receivable												
Inventory												
TOTAL CURRENT ASSETS												
Land												
Other Fixed Assets												
TOTAL ASSETS												
Due Banks												
Accounts Payable												
Federal Income Taxes												
TOTAL CURRENT LIABILITIES												
PREFERRED STOCK												
COMMON STOCK												
PAID IN SURPLUS												
EARNED SURPLUS												
NET WORTH (Proprietor or Partners)												
TOTAL LIABILITIES AND CAPITAL												
NET WORKING CAPITAL												
CURRENT RATIO												
TANGIBLE NET WORTH												
CONTINGENT DEBT												
Net Sales												
Net Profit												
Dividends or Withdrawals												
Res for Depreciation												
Res for Bad Debts												

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"Current Liabilities," "Deferred Liabilities," and "Capital Stocks and Surplus" In this way the figures to be analyzed will be relatively few in number and will be in a comparative form when there are two or more financial statements

If there are two or more balance sheets, the comparable items in each

Figure 37B Comparative Statement Blank of Dun & Bradstreet, Inc. *(reverse)*

COMPARATIVE STATEMENTS OF INCOME AND EXPENSE
(As Adjusted for Reporting Purposes)

PERIOD ENDED				
NET SALES				
COST OF GOODS SOLD				
GROSS PROFIT (LOSS) ON SALES				
EXPENSES				
Selling				
General				
Administrative				
NET INCOME (LOSS) ON SALES				
OTHER INCOME				
OTHER EXPENSES				
NET INCOME (LOSS) BEFORE TAXES				
Federal Income Taxes				
Other Taxes on Income				
NET INCOME (LOSS AFTER TAXES				
Adjustments—Add				
Adjustments—Deduct				
NET INCOME (LOSS) AS ADJUSTED				

SURPLUS OR NET WORTH RECONCILIATION

SURPLUS OR NET WORTH AT START				
ADDITIONS Adjusted Net Income				
DEDUCTIONS Adjusted Net Loss				
Dividends—Withdrawals				
SURPLUS OR NET WORTH AT END				

FINANCIAL RATIOS

Net Profits on Net Sales	%	%	%	%
Net Profits on Tangible Net Worth	%	%	%	%
Net Profits on Net Working Capital	%	%	%	%
Net Sales to Tangible Net Worth	Times	Times	Times	Times
Net Sales to Net Working Capital	Times	Times	Times	Times
Average Collection Period	Days	Days	Days	Days
Net Sales to Inventory	Times	Times	Times	Times
Fixed Assets to Tangible Net Worth	%	%	%	%
Current Debt to Tangible Net Worth	%	%	%	%
Total Debt to Tangible Net Worth	%	%	%	%
Inventory to Net Working Capital	%	%	%	%
Current Debt to Inventory	%	%	%	%
Funded Debt to Net Working Capital	%	%	%	%

Figure 38 Comparative Statement Blank of the Irving Trust Company, New York City

COMPARISON OF STATEMENTS OF FIRMS, INDIVIDUALS AND CORPORATIONS

($000 Omitted)

Name

Business

ASSETS	19	19	19	19	19	19
Cash						
U. S. Government Securities						
Marketable Securities						
Notes Receivable						
Accounts Receivable						
Inventory						
Plant & Equipment						
Less. Deprec. Reserve						
Net Fixed Assets						
Investment—Affiliates						
Due from Princ. Emp. & Affil.						
Investments Miscellaneous						
Deferred Charges						
TOTAL						
TYPE OF STATEMENT						
LIABILITIES						
Notes Payable—Banks & Brokers						
Notes Payable—Otherwise						
Current Funded Debt						
Acceptances under L/C						
Due to Princ. Emp. & Affil.						
Accounts Payable						
Accrued Items						
Income Taxes						
Reserves						
Term Debt						
Debentures						
Mortgage Debt						
TOTAL LIABILITIES						
Subordinated Debt						
Preferred Stock						
Common Stock						
Earned Surplus (Deficit)						
Capital Surplus						
TOTAL NET WORTH & SUB. DEBT						
TOTAL						
Current Assets						
Current Liabilities						
WORKING CAPITAL						
Current Ratio						
Contingent Liability						
Period under Review						
Sales						
Gross Profit						
Net Profit (Loss)						
Dividends—Cash						
Dividends—Stock						
Withdrawals						
Credits—Surplus						
Charges—Surplus						
Inventory Valuation						

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will be on the same line, thus making a running horizontal comparison relatively easy Figures 37A B and 38 give two such comparative statement forms A third appears in the credit file between Chapters I and II The figures from the oldest balance sheet posted on the comparative balance sheet form in this credit file are placed in the column marked "E," and succeeding balance sheets follow in chronological order The blank spaces in the left hand title column are available for items peculiar to one concern, such as the "Cash Surrender Value of Life Insurance," "Advances to Mills," or "Minority Interest," which may be inserted in longhand

Posting a comparative statement form is not quite so simple as just copying figures from one sheet of paper to another This analytical process begins to take on the refined attributes of European international politics when an audited financial statement of one concern carries "Cash Surrender Value of Life Insurance" as a current asset, while an audited statement of another concern carries this identical item as a slow asset, or when "Loans Due from Subsidiaries" is carried as a current asset by one auditor and as a slow asset by another, or when the current instalment of a serial mortgage is carried as a current liability by one auditor and never segregated from the total outstanding mortgage by another

Accounting practices are slowly but gradually headed for a high degree of uniformity by industries They have improved as a result of the better listing requirements of the New York Stock Exchange, the work of trade associations, the forms prepared by the Federal Reserve System, the activities of the American Accounting Association, the publication of research bulletins by the American Institute of Certified Public Accountants, and the accounting regulations of the Securities and Exchange Commission Nevertheless, many important problems still receive little uniformity of treatment by the accounting profession

The schedule for classifying balance sheet items (pages 193–196) was prepared from experience in posting many thousands of financial statements in almost every line of commercial and industrial activity and from every state in the Union This classification shows not only which items are current (i e , a current asset or a current liability) but also which are intangible As explained in the preceding chapter, any intangible item in the assets must be deducted from the sum of preferred and common capital stocks, surplus and undivided profits, to arrive at a figure representing "Tangible Net Worth" There are accountants and business specialists who differ on one or several items, but this classification has generally proved to be conservative, effective, and reliable from the points

Figure 39 Guide to Classification of Balance Sheet Items
(page 1)

Assets	Current	Slow	Intangible	Liabilities	Current	Slow	Net Worth
Accounts Receivable				Accounts Payable			
Customers (Less Reserves)	✓			For Merchandise.	✓		
From Affiliate, if concern				For Services.	✓		
is in healthy shape, and				To Directors.	✓		
accounts are being paid				To Employees	✓		
on regular terms.	✓			To Officers.	✓		
From Affiliate, if concern				To Partners	✓		
is in unhealthy shape, or				To Related Concerns. . .	✓		
accounts are not being				Sundry	✓		
paid on regular terms . .		✓		Accruals			
From Directors		✓		Commission	✓		
From Employees		✓		Interest.	✓		
From Officers.		✓		Other Expenses	✓		
From Partners		✓		Pay Rolls.	✓		
From Subsidiary, if concern				Rent	✓		
is in healty shape, and				Salaries	✓		
receivables are being paid				Taxes.	✓		
on regular terms	✓			Wages	✓		
From Subsidiary, if concern				Advances from Customers.	✓		
is in unhealthy shape, or							
accounts are not being				Bills Payable (same as			
paid on regular terms . .		✓		Notes Payable			
Miscellaneous.		✓		Bonds			
Other.		✓		Amount Maturing within			
Advances				One Year	✓		
For Merchandise	✓			Amount Maturing after			
For Mining Royalties .		✓		One Year		✓	

* Securities (stocks and bonds) listed on a national security exchange or which have an active over-the-counter market may be classed as current if readily marketable and valued not in excess of market. An exact list of these securities should be available to the banker who is examining the risk. Other securities, except Federal and state bonds, should be classed as non-current.

United States Government and state bonds may be classed as current when they are separately listed, regardless of whether or not the basis of valuation is known. This exception is made because the market price of these bonds varies only moderately from time to time. In conservative accounting practice, however, municipal securities should be valued at the lower of cost or market on statement date.

When securities listed on a national security exchange and United States Government bonds are grouped in one item, and the basis of valuation of the item as a whole cannot be ascertained, the grouped *item should be treated as non-current.*

Any security that is held for the purpose of controlling an interest in another corporation, and not as a short-term investment, should be carried as a slow asset.

† It is not unusual for a reserve for contingencies to be set up to obscure a definite liability or as a hidden valuation reserve. Where the item is an actual liability, the reserve should be classed as current. Where the item is a valuation reserve, as against inventory fluctuation, the sum should be deducted from the inventory figure in the assets, and the net inventory figure carried as a current asset. Where the item is a real reserve to meet some possible but not definite or clear obligation sometime in the future, such as a guaranty on the goodness, the life, or the performance of a product, it should be classed as a non-current (slow) liability.

Figure 39 (*Continued—page 2*)

Assets	Current	Slow	Intangible
For Traveling		✓	
To Affiliate		✓	
To Employees		✓	
To Subsidiary		✓	
Advertising			✓
Automobiles		✓	
Bills Receivable (same as Accounts Receivable)			
Blending Rights			✓
Bond Discount			✓
Bonds*	✓		
Bookplates			
At Cost			✓
Metal Value		✓	
Bottling Rights			✓
Brands Trade			✓
Building and Loan Shares	✓		
Buildings		✓	
Canadian Government Securities	✓		
Cash			
In Bank	✓		
In Closed Bank		✓	
In Sinking Fund		✓	
On Hand	✓		
Restricted		✓	
Cash Value of Life Insurance		✓	
Catalogues			✓
Claims for Refunds under Carry back Provisions of Tax Law	✓		
Coal Lands		✓	
Contracts			✓
Copyrights			✓
Debenture Discount			✓
Deferred Charges (See also Prepaid Items)		✓	
Deficit (profit and loss)			✓
Delivery Equipment		✓	
Deposits			
With Factor	✓		
With Mutual Insurance Company		✓	
With Workmen s Compensation Commission		✓	
Designs			✓
Development Expense			✓
Dies			✓
Docks		✓	
Drawings			✓
Emergency Plant Facilities		✓	
Equipment		✓	
Experimental Expense			✓
Exploration Expense			✓
Federal Government Securities (See United			

Liabilities	Current	Slow	Net Worth
No Definite Maturity Date	✓		
Capital (if partnership or proprietorship)			✓
Capital Stock			
A B or C Stock			✓
Common Stock			✓
Minority Interest		✓	
Preferred or Preference Stock			✓
Capital Surplus			✓
Chattel Mortgage	✓		
Common Stock			✓
Conditional Bill of Sale	✓		
Contingencies Reserve for †			
Contracts Payable	✓		
Credit Balance	✓		
Customers' Deposits	✓		
Debentures			
Amount Maturing within One Year	✓		
Amount Maturing after One Year		✓	
Deferred Credits or Income		✓	
Deferred Income		✓	
Deposits			
From Customers	✓		
From Employees	✓		
From Officers	✓		
From Salesman	✓		
Depreciation (deduct from Related Asset)			
Dividends Payable	✓		
Donated Surplus			✓
Due Factor	✓		
Earned Surplus			✓
Employees Deposits	✓		
Federal Income Taxes	✓		
Funded Debt			
Amount Maturing within One Year	✓		
Amount Maturing after One Year		✓	
Income Taxes	✓		
Loan from Factor	✓		
Loans Payable (same as Notes Payable)			
Minority Interest		✓	
Mortgages			

Figure 39 (*Continued—page 3*)

Assets	Current	Slow	Intangible
States Government Securities)			
Financing Expense			√
Fixed Assets		√	
Fixtures		√	
Foreign Assets—Restricted		√	
Formulas			√
Franchises			√
Furniture		√	
Good Will			√
Government Securities (See United States Government Securities)			
Improvements		√	
Insurance Deposits		√	
Insurance Premium, Prepaid		√	
Interest, Accrued		√	
Inventory			
Advances on Merchandise	√		
Finished Goods	√		
In Transit	√		
On Consignment	√		
Raw Materials	√		
Supplies		√	
Work in Process	√		
Investments*		√	
Investments in and Advances to Subsidiaries and Affiliates		√	
Land		√	
Lasts			√
Leasehold Improvements		√	
Leaseholds			√
Licenses			√
Life Insurance Cash Surrender Value		√	
Listed Securities*	√		
Loan to Affiliate		√	
Loan to Subsidiary		√	
Machinery		√	
Magazine Titles			√
Mailing Lists			√
Maintenance Materials and Parts		√	
Marketable Securities*	√		
Merchandise (See Inventory)			
Mineral Land		√	
Mines		√	
Miscellaneous Receivables		√	
Models			√
Mortgages Receivable		√	
Municipal Bonds	√		
Municipal Bonds in Default		√	
Notes Receivable (same as Accounts Receivable)			

Liabilities	Current	Slow	Net Worth
Amount Maturing within One Year	√		
Amount Maturing after One Year		√	
No Definite Maturity Date	√		
Net Worth (if partnership or proprietorship)			√
Notes Payable			
For Merchandise	√		
To Banks	√		
To Individuals	√		
To Others	√		
To Partners	√		
To Stockholders	√		
Term Loans (same as Bonds)			
Officers' Deposits	√		
Paid-in Surplus			√
Preferred or Preference Stock			√
Provision for Income Taxes	√		
Rent, Unpaid	√		
Reserves			
Bad Debts (deduct from Accounts Receivable)			
Contingencies†			
Depletion (deduct from Related Assets)			
Depreciation (deduct from Related Assets)			
Discounts (deduct from Accounts Receivable)			
Inventory Adjustments (deduct from Related Assets)			
Obsolescence (deduct from Related Asset)			
Retirement Capital Stock	√		
Self-insurance		√	
Taxes	√		
Unexpired Subscriptions		√	
Unrealized Profit		√	
Salaries	√		
Salesmen's Deposits	√		
Sales Lien	√		
Separation Allowances	√		
Social Security Taxes	√		
Stock			√
Stock Subscriptions	√		

Figure 39 (*Continued—page 4*)

Assets	Current	Slow	Intangible
Organization Expense			✓
Packaging and Shipping Items		✓	
Patents			✓
Patterns			✓
Pension Funds		✓	
Plant		✓	
Prepaid			
Insurance		✓	
Rent		✓	
Royalties		✓	
Supplies		✓	
Taxes		✓	
Processes			✓
Profit and Loss (deficit)			✓
Property		✓	
Quarries		✓	
Real Estate		✓	
Research Expense			✓
Revenue Stamps	✓		
Rights Publishing			✓
Royalties Prepaid		✓	
Securities*		✓	
Ships		✓	
Sight Drafts Outstanding	✓		
Sinking Fund		✓	
State Bonds	✓		
Stocks and Bonds*		✓	
Stock Subscriptions			✓
Subscription Lists			✓
Surplus (deficit)			✓
Timber (standing or uncut)		✓	
Tools		✓	
Tracings			✓
Trade Acceptances	✓		
Trade Brand			✓
Trademarks			✓
Trade Name			✓
Treasury Bonds		✓	
Treasury Stock			✓
Trucks		✓	
Unamortized Mortgage or Bond Expense			✓
United States Government Securities	✓		
Agencies of the Federal Government	✓		
Unlisted Securities*		✓	
Vessels		✓	

Liabilities	Current	Slow	Net Worth
Subordinated Debentures (same as Debentures)			
Sundry Accounts Payable	✓		
Surplus Account			
Capital Surplus			✓
Deficit (deduct)			✓
Donated			✓
Earned			✓
Paid In			✓
Profit and Loss—If Red (deduct)			✓
Surplus			✓
Surplus from Appreciation			✓
Undivided Profits			✓
Taxes Unpaid	✓		
Withheld at Source	✓		
Term Loans (same as Bonds)			
Trade Acceptances Payable	✓		
Unearned Income		✓	
Wages Unpaid	✓		

of view of bankers, credit men, accountants, security underwriters, brokers, and officials of business enterprises Though by no means complete, this schedule contains all the more commonly used items and many others

Explanations of Particular Items

The fifth step is concerned with additional information about particular figures in the financial statement. For instance, whenever a balance sheet contains an item of "Investments," an explanation—and a complete explanation, at that—must be obtained from the operating management or the accountant, because no one on this side of paradise, except the intimate members of the administrative staff, one or two members of the accounting department, and the auditors, could possibly have any idea of what it stands for. This item may represent any combination of the following interests: (1) controlling stock interests in one or several subsidiaries; (2) minority interest in other corporations; (3) investments in listed or over-the-counter securities; and (4) investments in corporations made for trade purposes or accepted in reorganizations.[13]

Study of Investments.—Even after a complete breakdown of an "Investment" item, the information essential for credit analysis is still incomplete. The basis of the valuation of each item must then be obtained. For instance, suppose an "Investment" item is carried in a balance sheet at $800,000 and has been broken down as shown in Figure 40 on page 198.

When given this schedule, the analyst must find out why the securities of the Carmel Candy Corporation are carried at $20,000, the securities of the Dunfran Sales Corporation at $60,000, and of Yaser & Co., Inc., at $80,000. These securities might be carried at cost or at book value, depending upon the accounting practice used. The stock in the Carmel Candy Corporation might have cost $20,000 ten years ago, and today a balance sheet of that corporation might show a tangible net worth of $100,000. Or, on the other hand, it might show a tangible net worth of only $2,000 and a bankrupt condition. If the book value is $100,000, the investment is naturally and wholeheartedly undervalued. Finally, the book value—that is, the tangible net worth—might be exactly $20,000, in which case everything is shipshape. The same situation is true with the investments in Dunfran Sales Corporation and in Yaser & Co., Inc., with those in the two corporations in which minority interests are held, Webb-Sull Co., Inc., and Frederick Jobbers, Inc., and with the various concerns in which financial interests are held for trade purposes.

"Investments in Marketable Securities" must be analyzed in a similar manner after obtaining a detailed list of the securities and the value at

[13] Prior to 1933, when the New York Stock Exchange carried on extensive correspondence with the officers of Allied Chemical and Dye Corporation, some corporations even carried their own treasury stock under "Investments."

which each is carried These securities might conservatively be carried at 'cost or market whichever lower" On the other hand, the cost basis might be employed, and the market value might be $100 000 or $200 000 under or over this figure [14]

Even an investment of only one dollar should never be overlooked in the investigation. The analyst can no more forget about that dollar than an aviator can forget which way the wind is blowing when he is trying

Figure 40 Breakdown of an Investment Item into (1) Investments in Subsidiaries (2) Minority Interests, and (3) Miscellaneous Investments

		Value on the Books
Carmel Candy Corporation	$20 000 00	
Dunfran Sales Corporation	60 000 00	
Yaser & Co Ltd	80 000 00	
Investments in Subsidiaries		$160 000 00
Webb-Saul Co Inc	70 000 00	
Frederick Jobbers Inc	60 000 00	
Minority Interests		130 000 00
Investments in Marketable Securities		460 000 00
Miscellaneous investments in capital stocks of customers restaurants hotels etc		50 000 00
Total Investments		$800 000 00

for a three point landing In one case a situation came to light wherein the one dollar represented the controlling stock interest in a corporation with a tangible net worth of $26 000, to which the parent corporation (being investigated) had advanced $76 000 The subsidiary was headed for bankruptcy, and the $76 000 advance was gone completely

One of the most important axioms to follow in the analysis of balance sheets is never to overlook an Investment item Always find out as fully

[14] In preparing their annual statements, practically all insurance companies, societies, and associations use values given in *Valuation of Securities* This book is issued in January of each year by the Committee on Valuation of Securities of the National Association of Insurance Commissioners. It shows the values to be used in the statements as of December 31 of the preceding year for practically all of the bonds and stocks owned, or used as security for loans from insurance companies. The introduction of the December 31 1958 issue of this book contains the following statement "Valuation for all stocks and bonds shall be the market quotation as of December 1 1958 (or the latest quotation prior thereto if a December 31, 1958 quotation is not available) excepting that for bonds secured by the full faith, credit and taxing power of political subdivisions of the Dominion of Canada which are not in default as to principal or interest on December 1 1958 the Association value shall be the amortized value at December 31 1958 "

as possible what the item represents, how the component parts are valued, and what the actual current economic value of each part really is. Then only is a solid basis for deduction really at hand.

Study of Various Miscellaneous Receivables and Payables.—A second group of items requiring thorough analysis might bear any one of the following captions:

Miscellaneous Receivables
Due from Officers and Employees
Due from Subsidiaries
Due from Subsidiaries and Affiliates
Due to Officers and Employees
Due to Subsidiaries
Due to Subsidiaries and Affiliates

These items ordinarily have one thing in common: that they do not arise in the regular course of business. Miscellaneous receivables might arise from loans, from intercompany sales, or from the sale of fixed assets and other items not normally carried in the inventory. The account carries no real meaning, however, until a full explanation is obtained as to how much, if any, is due from officers, employees, subsidiaries, affiliates, and other enterprises. Then after such a breakdown is obtained, the experienced analyst goes three steps farther and learns (1) how each particular transaction arose, (2) when payment is due, and (3) the financial responsibility of the debtor, so that some logical deduction may be drawn as to whether the asset is likely to remain unchanged or to change only a little in the near future, or to be liquidated shortly and paid in full.

How did the item "Due from Officers and Employees" arise? Does it represent advances that are being paid off weekly or monthly, or does it represent an item that has remained frozen for several years? Does the ability to repay depend upon increased salaries or dividends from the concern itself? Loans and advances of this nature which turned into bad debts have crippled many business organizations. What is likely to occur in the particular case?

The same procedure must be followed in getting behind the items "Due from Subsidiaries" and "Due from Subsidiaries and Affiliates." The analyst must also ascertain whether these accounts represent monetary loans or merchandise sales. In the case of loans, he must ascertain further the use made of the funds by the subsidiaries or affiliates. Advances may be used to carry merchandise and receivables through the peak of a season and may be repaid as the receivables are collected. On the other hand, the funds may be used to enlarge a factory and may be repaid only out of

earnings, as, if, and when earned. There have been items of "Due from Subsidiaries" that have remained unchanged in amount for fifteen years on the books of a parent corporation and that may remain unpaid for fifteen years more, and, on the other hand, many such loans have been retired periodically after the peak of a season.

The situation is reversed when the analyst faces such items as "Due to Officers and Employees," "Due to Subsidiaries," and "Due to Subsidiaries and Affiliates." How and why did each item arise? Did the corporation need funds that could be obtained only from these unusual sources? Are parts of the salaries and the wages being paid by interest-bearing notes, or have heavy dividends been declared but really left in the business as a current liability? Did the parent corporation need funds and so draw upon the subsidiaries and affiliates? Have the loans remained with little or no change from year to year, or are they paid off in full periodically? Is the amount due for the purchase of merchandise, and, if so, are these purchases made on regular or special terms and then paid on those terms?

No fact, no clue, no explanation should be overlooked. The analyst must obtain as much information as possible about the various assets that are not clear by their very caption, in order to form an independent and enlightened opinion regarding their actual value. Accountancy, after all, is not an absolute profession. This fact has nowhere been emphasized more clearly than in the following excerpt from a report prepared in 1932 by a committee of the American Institute of Certified Public Accountants, which pointed out the difficulties inherent in the accounting practice of big business. Since then these problems have grown larger.

> In an earlier age, when capital assets were inconsiderable and business units in general smaller and less complex than they are today, it was possible to value assets with comparative ease and accuracy and to measure the progress made from year to year by annual valuations. With the growing mechanization of industry, and with corporate organizations becoming constantly larger, more completely integrated and more complex, this has become increasingly impracticable. From an accounting standpoint, the distinguishing characteristic of business today is the extent to which the expenditures are made in one period with the definite purpose and expectation that they shall be the means of producing profits in the future, and how such expenditures shall be dealt with in accounts is the central problem of financial accounting. How much of a given expenditure of the current or a past year shall be carried forward as an asset cannot possibly be determined by an exercise of judgment in the nature of a valuation. The task of appraisal would be too vast, and the variations in appraisal from year to year due to changes in price levels or changes in the mental attitude of the appraisers would in many cases be so great as to

reduce all other elements in the computations of the results of operations to relative insignificance.[15]

These explanations of how to analyze such items as "Investments" and "Miscellaneous Receivables" have been outlined merely to give a picture of the approach to the sixth step in preparing figures for analysis. What does the item mean? How is it valued? What is it really worth? These are the typical foundamental questions which must be asked about most of the assets in balance sheets. When the answers are not obtained, the analysis at times degenerates, notwithstanding extreme care, to guesswork. So when any other items appear that are not self-explanatory—such as "Riparian Rights," "Will-Call Receivables," "Due from Factor," "Organization Expense"—the analyst must without exception seek the answers to these three pertinent questions.

Study of Trend of Comparative Figures

The sixth step is a study of the comparative figures from one year to another, as posted on the comparative statement form. This process is known as "comparative statement analysis," and particular attention is given to unusual fluctuations, especially between the figures of the last two years. An explanation for these fluctuations may be sought from the active management. An increase in tangible net worth may result from undistributed profits, a write-up of property assets, or additional funds invested in the business. On the other hand, a decline in tangible net worth may be caused by an operating loss, dividend disbursements in excess of current earnings, or a write-down in property assets. Similarly, an increase in inventory may have been planned to take care of greatly increased net sales. On the other hand, inventory may be piled up because of decreased sales or in anticipation of higher prices. Each explanation carries a different meaning to the experienced credit analyst. Besides each individual item on the current balance sheet, the net working capital, net sales, net profits, and dividends or withdrawals should be surveyed and compared with the corresponding figures of the previous year. When the variation is large, additional information should always be obtained. The information secured in this manner is absolutely essential for a comprehensive analysis of the figures.

[15] Report of Committee of American Institute of Certified Public Accountants on Cooperation with Stock Exchanges on *Value and Limitations of Corporate Accounts and General Principles for Preparation of Reports to Stockholders*, George O. May, chairman, rendered September 22, 1932, p. 4.

INTERNAL ANALYSIS

Internal analysis is the process of measuring the relative size and importance of strategic items or groups of items in a financial statement. The object of the analysis is to determine whether the receivables, the inventory, the fixed assets, the payables, the sales, and the profits are in satisfactory proportions. Explanations have already been obtained from the management of the reasons for substantial increases or decreases in these same items between the last two fiscal balance sheets and, whenever possible, since the issuance of the last fiscal balance sheet. When one or more items are out of line, the analyst is warned of a weakened or weakening financial condition. Recognized in time, this condition may often be corrected by an aggressive management or by the insistence of an interested banker. If timely action is not taken, the inevitable result is difficult operations, bankruptcy, or voluntary liquidation.

Ratios

Fourteen comparisons of specific items and groups of items should invariably be made in the internal analysis. For convenience, these ratios may be divided into five family groups:

1. Capital ratios
   a. Fixed assets to tangible net worth (per cent)
   b. Current debt to tangible net worth (per cent)
   c. Funded debt to net working capital (per cent)
2. Inventory ratios
   a. Net sales to inventory (times)
   b. Inventory to net working capital (per cent)
   c. Current debt to inventory (per cent)
3. Sales ratios
   a. Average collection period (days)
   b. Net sales to tangible net worth (times)
   c. Net sales to net working capital (times)
4. Net profit ratios
   a. Net profits on net sales (per cent)
   b. Net profits on tangible net worth (per cent)
   c. Net profits on net working capital (per cent)
5. Supplementary ratios
   a. Current assets to current debt (times)
   b. Total debt to tangible net worth (per cent)

A comprehensive discussion of the importance and significance of these ratios is worthy of a volume in itself.[16] Obviously, excessive fixed assets weaken a financial structure by bringing excessive depreciation charges into the income account and by cutting into the necessary amount of net working capital. A concern with top-heavy liabilities is likewise in a weakened condition to be tossed about by the winds of the business world. When net working capital is exceeded by the funded debt, all of the concern's own capital is tied up in non-liquid assets, and operations are carried on from day to day on borrowed funds. This condition may increase the burden of interest and amortization charges beyond the varying profit limits and lead to financial difficulty. Each of the other groups of ratios plays a part in revealing ailments and in suggesting suitable remedies to the skilled analyst.

Typical ratios will naturally vary materially in different lines of business activity and under different phases of the business cycle. Because of differences in the products produced or handled, the extent of manufacturing and housing facilities, marketing methods, competition, and other factors, no two industries or companies are exactly comparable. For instance, a comparison of the annual net sales to the closing inventory which would give a figure of 10 times would be high for wholesalers of hardware and retailers of men's and boys' clothing, lines of business activity that might normally have a figure between 3.5 and 4 times, and low for wholesalers of fresh fruits and produce, which might show a turnover of 25 to 35 times.

A comparison of the aggregate value of fixed assets to the tangible net worth shows similar diversity. A ratio of 30 per cent would be excessive for a converter of cotton piece goods, which requires only a nominal investment in furniture and fixtures. This same ratio would be admirable for a manufacturer of paper, which requires large mills, immense machinery, and, in some cases, extensive holdings of timberlands. Then, within each industry there are naturally wide variations in particular ratios from one business enterprise to another, because of differences in managerial foresight, knowledge, and experience.

Although this is so, an attempt has been made to summarize into definite guides the relationships that must normally be observed for the profitable and healthy operations of commercial and industrial business enterprises. Where the financial set-up of a concern varies widely from one or more of the relationships outlined in these summaries, the enterprise is not necessarily headed for financial difficulty, but it is an indication that the man-

[16] See Roy A. Foulke, *Practical Financial Statement Analysis* (5th ed.; New York: McGraw-Hill Book Co., Inc., 1961).

agement needs to go over its policies again and probably to revamp them, and that the loaning banker should take an increasingly active and constructive interest in the account.

Summary of Marginal Ratios

At the end of this chapter are given five-year running averages covering three different five-year periods for seventy lines of industrial and commercial activity. The successful well managed enterprise with its tangible net worth in excess of $75,000 will generally show ratios that are better than the average. On the other hand, ratios that are qualitatively poorer and that would be vulnerable if maintained over a period of years may reach a strategic peak on some one fiscal statement, and then be brought into line by an active management which realized improvement was necessary for prolonged successful operation. With this in mind, the following interpretations of internal ratios of commercial and industrial business enterprises are quoted from *Behind the Scenes of Business*[17] on four of the groups of ratios.

Standards for Capital Ratios —

When a commercial or industrial business enterprise has a tangible net worth between $75,000 and $250,000, its operations should be carefully analyzed if the depreciated value of its fixed assets is greater than two-thirds of the tangible net worth, or if the current debt is greater than two-thirds of the tangible net worth. When the tangible net worth exceeds $250,000, its affairs should be followed closely if the depreciated value of its fixed assets totals more than three-quarters of the tangible net worth, or if the current debt is greater than three-quarters of the tangible net worth.

In no case should the funded debt be larger than the net working capital.

These three comparisons of balance sheet items are outstanding signposts of financial strength, credit stability, and business health.[18]

Standards for Inventory Ratios —

When a manufacturer, a jobber, or a wholesaler is operating on a tangible net worth between $75,000 and $250,000, extreme care should be exercised, even though the ratio of net sales to inventory seems in satisfactory relationship, if the inventory is greater than two-thirds of the net working capital. When the tangible net worth exceeds $250,000, the inventory should be no greater than three-quarters of the net working capital.

In a retail business with a tangible net worth in excess of $75,000, the inventory should be no larger than the net working capital. An excessive inventory is a material drag and often results in heavy unexpected and untimely losses.

[17] Roy A. Foulke, *Behind the Scenes of Business* (rev. ed., New York: Dun & Bradstreet, Inc., 1952).

[18] *Ibid.*, p. 30.

due to depreciation, changes in style, perishability, and constant price fluctuations.[19]

Average ratios of net sales to inventory, of inventory to current debt, and of net working capital to inventory are given at the end of this chapter for different divisions of industry and commerce.

Standards for Sales Ratios.—The principal net sales relationships are average collection period, turnover of tangible net worth, and turnover of net working capital. Average collection periods are given at the end of this chapter for various lines of business. The average collection period of any concern, however, should bear a relationship more to its own terms of sale than to some general average. Turnovers of tangible net worth and of net working capital rise and fall together depending upon the volume of net sales. When the sales volume is not sufficiently large, a concern undertrades, has too much money in the business, or assumes losses because of the inadequate volume of business.

On the other hand:

> The operation of a commercial or industrial business enterprise, which is trading heavily, is based upon an anticipated volume of business. Forward commitments invariably are placed for its requirements of raw material or finished merchandise to handle the expected volume. If expected orders fail to materialize, if certain important orders already received and confirmed are cancelled and for business reasons the cancellations are accepted; if a strike occurs at its plant and the inventory continues to increase with the receipt of raw material; if any one of these factors happens to materialize and to last for a period of one to three months, then the liabilities, already heavy, must con*tinue to expand just at the time when the income, to meet these larger obli*gations, is rapidly dropping.
>
> That is an almost ideal combination for financial embarrassment. The ceiling falls and no landing place is discernible through the clouds. Funds to meet the increasing liabilities are lacking. In the business world, there are two indications of stress and strain from overtrading, from great speed. These are the comparisons of net sales to net working capital and of net sales to tangible net worth. They should be watched closely, particularly as sales expand.[20]

Standards for Net Profit Ratios.—Net profits represent the end of the rainbow for economic activity, for manufacturing, for the buying and selling of merchandise. In comparative credit analysis, net profits are expressed as percentages of net sales, of tangible net worth, and of net working capital. Each of these ratios is of primary interest, since profits are the basic purpose and final criterion of successful operation. However, the analyst must go back to the other ratios measuring liquidity and solvency

[19] *Ibid.*, p. 44. See also Foulke, *Inventories and Business Health* (New York: Dun & Bradstreet, Inc., 1960).

[20] *Ibid.*, p. 64.

to be assured that future earning capacity is not being impaired by a desire to show immediate profits.

During the upward swing of the business cycle toward the peak, the theory of a large volume and a small profit becomes almost a national motto. Such a period in our economic life is generally followed by depressed activity, when many industries—particularly those specializing in the manufacture of durable products or products utilized in erecting, furnishing, and equipping homes, office buildings, apartments, lofts, and plants—are unable to obtain a reasonable volume at any price. In many retail stores merchandise of lower quality is offered to the consumer at lower and lower prices.

An enterprise managed solely on the volume and price theory generally needs constant watching by the officials of the business, its trade creditors, and its bankers. There is always the possibility of trouble in the background through a breakdown of demand brought about by some unforeseen event, the unexpected effect of a new policy, or a change in style, and if liabilities are heavy, trouble invariably is in the offing. A business concern, like the human body, must have reserve strength available for every possible emergency.

Average Ratios

The fourteen important average ratios listed on pages 208 to 213 for seventy different lines of industry and commerce—forty-two manufacturers, twenty-one wholesalers, and seven retailers—for three different five-year periods, give a fairly wide basis for comparison in analyzing the internal financial condition of concerns in these particular lines of business. These ratios indicate the great variations in different lines of industrial and commercial activity. Practical application of these ratios will be found in the actual cases analyzed in Chapter XXIV. Explanations of the terms used in these ratios follow:

Average Collection Period.—Denotes number of days the total of trade accounts and notes receivable (including assigned accounts and discounted notes, if any), less reserves for bad debts, represents when compared with the annual net credit sales. To compute this figure, first divide the annual net credit sales by 365 days to obtain the average credit sales per day. Then divide the total of accounts and notes receivable (plus any discounted notes receivable) by the average credit sales per day to obtain the average collection period. Alternatively, the same result is obtained by dividing net receivables into net credit sales, and then dividing the quotient into 365 days.

Current Assets.—Current assets consist of cash on hand and in banks; accounts and notes receivable for the sale of merchandise in regular trade quarters, less any reserves for bad debts; advances on merchandise; inventories, less any reserves, securities carried not in excess of market, municipal bonds carried not in excess of market; and United States Government and state securities. *Quick assets are the current assets exclusive* of inventories.

Current Debt.—Current liabilities are all liabilities due within one year from statement date, including current payments on serial notes, mortgages, debentures, or other funded debts. Included also are liability reserves, such as gross reserves for Federal income taxes and for contingency reserves set up for specific purposes. Valuation reserves (such as for depreciation) and surplus reserves (such as for remote contingencies) are not included.

Fixed Assets.—Fixed assets are the sum of land and the depreciated book values of buildings, leasehold improvements, fixtures, furniture, machinery, tools, and equipment.

Funded Debt.—Mortgages, bonds, debentures, notes, serial notes, or other obligations with a maturity of more than one year from the statement date.

Inventory.—The sum of raw material, material in process, and finished merchandise constitutes inventory. Supplies are usually treated as a deferred asset, rather than as part of the inventory, for the purpose of credit analysis.

Net Profits.—Net profits represent the income before dividends, but after all operating expenses, bad debt losses, inventory adjustments, depreciation, fixed charges and Federal and State income taxes.

Net Sales.—The annual dollar volume of business transacted, less deductions for returns, allowances, and discounts.

Net Sales to Inventory.—This is the quotient obtained by dividing annual net sales by statement of inventory. This quotient does not represent the actual physical turnover, which would be determined by reducing the annual net sales by the percentage of gross profit, or by taking the inventory at selling prices.

Net Working Capital.—The difference between the current assets and the current liabilities.

Tangible Net Worth.—Tangible net worth is the sum of outstanding preferred stock and outstanding common stock, surplus, and undivided profits, less intangible assets. The intangible deductions are such items as good will, trademarks, patents, copyrights, mailing lists, organization expenses, and underwriting discounts and expenses.

Figure 41 Fourteen Important Ratios for Seventy Lines of Business Based upon Averages for Three Five-Year Periods‡

Line of Business	Five Year Periods	Current Assets to Current Debt	Net Profits on Net Sales	Net Profits on Tangible Net Worth	Net Profits on Net Working Capital	Net Sales to Tangible Net Worth	Net Sales to Net Working Capital	Collection Period	Net Sales to Inventory	Fixed Assets to Tangible Net Worth	Current Debt to Tangible Net Worth	Total Debt to Tangible Net Worth	Inventory to Net Working Capital	Current Debt to Inventory	Funded Debts to Net Working Capital
		Times	Per Cent	Per Cent	Per Cent	Times	Times	Days	Times	Per Cent	Per Cent	Per Cent	Per Cent	Per Cent	Per Cent
Agricultural Implements and Machinery	1954-58	3 1	[illegible]	4	9 [illegible]	[illegible]	[illegible] 04	31	3 [illegible]	[illegible] 0	4 4	[illegible] 1	70 8	50 1	[illegible]9 5
	1955-59	[illegible] 7		7	9 [illegible]	[illegible] 1	[illegible]		[illegible]	30 8	7 4	[illegible] 0	77 8	[illegible]	[illegible]
	1956-60	[illegible]			0 [illegible]	[illegible]	[illegible]		[illegible]	[illegible]	6.1	[illegible] 7	76 8	53 8	[illegible] 7
Airplane Parts and Accessories	1954-58	1 79		4	4	[illegible]	[illegible]	4	5.8	43 7	78.1	106 1	11 7	111 5	44 1
	1955-59	1 8		0		[illegible]	[illegible] 74	4	6.7	45 5	77 4	101 9	10 2	[illegible]	47 0
	1956-60	[illegible]	54	9	1	9	[illegible] 1	49	5 3	48 7	[illegible]	1 6 2	100 5	109 1	41 6
Automobile Parts and Accessories	1954-58				4	44	4 00		5 9	40 4	[illegible] 6	63 [illegible]	75 0	79 1	27 7
	1955-59	8	0	9 1	[illegible] 4	[illegible] 48	4 [illegible]	8	[illegible] 0	39 4	34 0	63 8	79 2	83 [illegible]	[illegible] 7
	1956-60	[illegible] 8	[illegible]	9	7	[illegible]	4 [illegible]	8	5 9	56 9	30 8	65 3	7 6	79 5	30 4
Bakers	1954-58	[illegible]	[illegible]0			4 79	[illegible] 77	2	25.9	[illegible] 0	29 4	60 9	72 5	161 4	77 5
	1955-59	1 [illegible]	4	95	[illegible]	4 [illegible]	15 76	[illegible]	26 [illegible]	71 9	[illegible]9 5	47 4	[illegible]9 1	[illegible]1 8	77 3
	1956-60	7	1 [illegible]	7 1	[illegible]	4 4	1 4		[illegible] 1	[illegible] 4	18 9	48.9	[illegible] 4	[illegible] 3	[illegible] 4
Bedsprings and Mattresses	1954-58	[illegible] 1	4	[illegible] 0	[illegible]		4 76	4	7 8	7 3	[illegible] 4	70 8	[illegible] 4	[illegible] 3	24 3
	1955-59	[illegible]5	10	[illegible] 7	9 8	9	8	4	7 9	26 2	24 8	54 1	63 7	[illegible]3 8	24 5
	1956-60	[illegible]4	1 89	5 [illegible]	8	[illegible]7	[illegible]	[illegible]	8	25 9	24 5	80 1	[illegible]3 9	64 6	28 2
Bodies, Auto, Bus and Truck	1954-58	2 [illegible]	[illegible] 44	7	9	[illegible]	5 7	[illegible]	1	4 5	36 0	74 6	79 7	74 0	27 4
	1955-59	[illegible] 5	1	4	[illegible]		5 2	[illegible]	6 [illegible]	[illegible]8 9	37 0	75 3	84 8	73 7	2[illegible] 9
	1956-60	94	[illegible]	[illegible]	[illegible]	[illegible]	4 [illegible]7	4	6 5	[illegible]8 6	[illegible]	71 6	84 1	72 3	27 4

‡ These tables are quoted from *Current Trends in Terms of Sale*, and *Inventories and Business Health* by Roy A Foulke, and a pamphlet, *How Does Your Business Compare with Others in Your Line* (New York Dun & Bradstreet, Inc, 1959, 1960, and 1961, *respectively*)

* Building construction and electrical contractors have no inventories in the credit sense of the term The former carry only materials such as lumber, bricks, tile, cement, structural steel, and building equipment to complete particular jobs on which they are working The latter carry electrical equipment and supplies to complete jobs on which they are working Concerns in these lines generally have no customary selling terms, each contract being a special job for which individual terms are arranged

§ *Job printers* have no inventories in the credit sense of the term They carry only current supplies, such as paper, ink, binding materials, and lead type-casting

† Part of the annual sales were for cash, and part were on charge accounts To obtain an average collection period, it would have been necessary to deduct the amount of the cash sales from the annual net sales and then to have determined the average number of days for which the accounts and notes receivable were outstanding based upon the resultant yearly charge sales. This information was available in too few cases to obtain an average collection period which could be used as a broad guide

Figure 41 (*Continued*)

Bolts, Screws, Nuts, and Nails	1954-58	3.05	3.52	8.29	16.18	2.53	4.33	29	5.9	48.9	25.6	56.6	74.0	72.3	40.9
	1955-59	3.01	3.55	9.02	17.55	2.63	4.41	30	6.0	50.3	26.7	58.1	76.8	72.6	41.7
	1956-60	3.09	3.34	8.45	15.85	2.69	4.45	29	6.0	49.9	25.7	56.6	76.4	72.4	40.1
Breweries	1954-58	2.43	1.91	4.23	13.72	2.42	9.16	20	17.9	71.4	20.9	37.1	50.7	147.0	51.7
	1955-59	2.46	2.22	4.79	15.14	2.40	8.86	20	18.2	71.2	21.2	38.4	49.6	143.1	55.6
	1956-60	2.49	2.67	5.64	18.66	2.38	8.68	19	17.9	69.5	21.5	39.6	50.3	131.6	56.2
Chemicals, Industrial	1954-58	2.63	5.21	10.67	21.96	2.01	4.13	37	7.1	53.9	30.7	61.6	62.5	99.7	49.4
	1955-59	2.63	4.94	10.93	22.46	2.09	4.31	39	7.3	54.8	30.4	62.0	62.7	98.4	50.4
	1956-60	2.73	4.45	10.38	20.65	2.13	4.35	39	7.0	53.6	29.1	60.8	63.0	94.0	52.2
Coats and Suits, Men's and Boys'	1954-58	2.49	0.91	4.20	4.95	4.29	4.96	48	6.0	7.3	59.1	108.6	81.5	82.1	22.5
	1955-59	2.39	0.95	4.36	5.17	4.46	5.14	48	5.8	7.0	62.9	115.0	83.5	84.0	21.2
	1956-60	2.37	0.93	4.53	5.35	4.50	5.17	50	5.9	6.7	63.4	111.8	82.8	86.7	20.6
Coats and Suits, Women's	1954-58	2.07	0.93	6.36	8.40	5.63	7.07	35	11.3	7.2	76.5	113.2	74.1	122.2	32.1
	1955-59	1.95	0.86	6.55	8.50	5.88	7.66	36	10.6	7.3	83.7	120.6	77.3	125.2	29.0
	1956-60	1.91	0.87	6.83	8.48	6.51	8.38	37	10.6	7.1	87.5	131.0	77.9	132.4	30.8
Confectionery	1954-58	3.09	2.11	6.48	11.66	2.93	6.16	20	8.3	41.8	23.6	50.4	69.6	68.2	34.8
	1955-59	2.91	1.96	6.62	11.33	2.93	6.27	20	8.2	41.4	25.7	49.9	73.5	69.8	33.5
	1956-60	2.84	2.02	7.21	12.12	3.02	6.36	21	8.5	41.3	26.3	47.9	71.4	77.5	31.5
Contractors, Building Construction	1954-58	1.78	1.49	9.49	14.96	6.21	9.84	*	*	21.6	74.6	113.3	*	*	21.6
	1955-59	1.77	1.50	9.54	15.10	6.25	9.51	*	*	21.7	76.6	118.0	*	*	20.4
	1956-60	1.74	1.42	9.61	15.24	6.45	9.52	*	*	21.0	79.0	123.1	*	*	20.9
Contractors, Electrical	1954-58	2.58	2.33	10.43	13.85	4.57	5.99	*	*	16.2	49.7	86.3	*	*	26.1
	1955-59	2.53	2.12	10.37	14.05	4.60	5.99	*	*	15.9	50.5	91.1	*	*	24.0
	1956-60	2.54	2.15	9.65	13.17	4.45	5.58	*	*	15.2	49.8	88.3	*	*	21.3
Cotton Cloth Mills	1954-58	4.34	1.98	3.55	7.46	1.89	3.84	36	4.6	48.7	17.4	44.4	78.7	44.3	29.6
	1955-59	4.42	2.24	3.98	8.45	1.93	3.88	35	4.8	48.9	16.9	43.2	74.7	43.1	28.9
	1956-60	4.37	2.43	4.43	9.37	1.83	3.89	36	4.9	48.0	16.2	37.4	74.2	43.5	26.0
Cotton Goods, Converters Non-Factored	1954-58	2.88	1.31	4.80	5.60	3.23	3.42	49	5.6	1.4	45.3	119.1	78.8	70.2	31.8
	1955-59	2.64	1.16	4.41	5.09	3.97	4.14	46	5.7	1.3	53.1	120.9	79.6	81.2	28.2
	1956-60	2.50	1.06	4.13	4.85	4.46	4.78	43	7.2	1.3	60.9	122.5	83.3	80.7	27.4
Dresses, Rayon, Silk and Acetate	1954-58	1.85	0.51	5.29	7.09	10.85	13.40	33	18.2	8.7	91.8	139.4	70.5	173.2	35.5
	1955-59	1.82	0.46	5.05	7.24	10.78	13.47	32	17.8	8.7	93.7	128.0	72.5	176.8	34.6
	1956-60	1.80	0.45	5.04	7.36	10.48	13.95	32	16.5	8.7	95.4	121.9	74.2	196.3	34.5
Drugs	1954-58	3.05	8.50	15.67	27.37	1.99	3.10	42	5.4	37.6	29.0	55.0	61.4	74.9	30.3
	1955-59	3.15	8.52	15.89	26.95	2.03	3.15	42	5.7	36.5	29.7	55.3	60.5	78.7	27.2
	1956-60	3.16	8.50	15.83	26.00	2.01	3.19	43	5.6	37.1	28.9	53.3	61.2	80.2	24.2
Electrical Parts and Supplies	1954-58	2.96	3.80	10.50	14.93	2.78	4.52	38	5.0	34.9	34.4	64.4	78.7	70.2	25.6
	1955-59	2.89	3.90	10.87	15.76	2.78	4.43	40	4.8	35.4	35.5	66.4	80.6	70.0	27.8
	1956-60	2.98	3.84	10.69	15.54	2.68	4.25	41	4.9	36.4	33.1	66.4	79.2	68.6	27.5
Foundries	1954-58	3.20	3.46	8.01	15.18	2.49	4.79	34	7.9	48.1	24.4	48.3	54.9	87.6	31.3
	1956-59	3.15	3.62	8.45	15.93	2.48	4.62	36	7.9	47.3	25.2	50.3	55.2	91.4	31.0
	1956-60	3.26	3.16	7.31	14.02	2.46	1.60	34	7.9	47.6	23.9	49.5	54.2	89.0	29.7
Fruits and Vegetables, Canners	1954-58	2.06	2.04	5.45	10.83	2.98	5.46	20	3.6	49.9	49.6	92.7	147.9	63.4	37.1
	1955-59	2.05	1.88	4.93	9.91	2.96	5.27	20	3.5	47.0	50.9	96.4	153.2	66.5	35.2
	1956-60	2.05	1.97	5.52	10.41	3.02	5.56	20	3.6	45.9	54.4	92.4	150.9	67.5	33.5

Figure 41 (*Continued*)

Furniture	1954-58	3.17	2.57	8.06	12.32	2.93	4.66	42	6.4	31.6	29.6	61.2	67.7	71.6	25.6
	1955-59	3.06	2.66	8.64	13.32	3.03	4.92	43	6.6	32.1	31.2	61.6	70.6	72.2	25.0
	1956-60	3.03	2.47	7.64	12.66	2.92	4.70	43	6.0	32.3	30.0	62.6	71.1	71.3	24.2
Hardware and Tools	1954-58	[illegible]	4.45	9.64	14.75	2.13	3.19	38	4.5	33.4	25.9	48.1	74.6	56.3	26.7
	1955-59	3.54	4.29	9.02	14.87	2.24	3.46	30	4.6	33.3	27.0	46.6	72.2	56.6	26.9
	1956-60	3.62	3.66	8.26	13.34	2.29	3.64	38	4.8	34.7	25.9	47.8	73.4	55.0	29.8
Hosiery	1954-58	3.56	1.44	3.84	7.42	2.26	4.65	33	5.5	45.4	20.5	66.5	72.3	55.5	36.3
	1955-59	3.51	1.74	4.16	8.71	2.28	4.49	35	5.5	44.7	20.4	60.3	73.0	55.5	40.4
	1956-60	3.30	1.70	4.02	8.08	2.27	4.65	35	5.5	44.6	20.6	62.4	74.9	55.8	41.1
Lumber	1954-58	3.38	4.63	7.69	16.11	1.76	4.03	31	5.4	36.6	18.2	30.7	74.2	59.0	45.9
	1955-59	3.41	4.43	8.11	15.39	1.79	3.77	32	5.4	37.0	18.5	30.6	74.5	59.7	48.4
	1956-60	3.36	3.64	6.83	17.18	1.78	3.30	39	5.3	38.6	18.0	30.8	76.8	58.7	51.0
Machine Shops	1954-58	3.04	3.04	8.97	15.49	2.11	3.98	36	6.4	44.2	27.7	52.5	67.3	65.4	31.0
	1955-59	3.01	3.33	7.69	13.7	2.04	4.1	30	6.3	45.8	28.3	54.7	68.6	64.1	34.5
	1956-60	3.05	3.28	7.72	13.77	1.07	4.2	38	7.0	46.6	27.4	51.5	65.8	63.6	35.4
Machinery Industrial	1954-58	3.10	3.63	9.05	13.90	2.30	3.55	45	4.6	33.6	32.3	59.9	72.6	70.7	24.4
	1955-59	3.14	3.32	8.73	13.9	2.35	3.[illegible]	47	4.5	33.4	30.0	59.7	73.1	70.9	24.4
	1956-60	3.27	3.84	8.44	12.89	2.25	3.8	47	4.5	33.6	29.9	56.6	71.8	67.6	24.4
Meats and Provisions Packers	1954-58	2.21	0.73	6.40	15.17	6.20	17.63	1	24.9	59.6	4.8	69.3	75.4	107.4	40.5
	1955-59	2.22	0.09	7.16	17.78	7.03	17.1	12	25.6	60.5	35.2	62.7	73.8	109.7	50.4
	1956-60	2.8	0.03	7.01	17.04	7.50	16.98	2	25.3	61.3	34.6	69.0	73.3	108.4	52.4
Metal Stampings	1954-58	2.98	3.55	9.36	16.16	2.59	4.99	34	6.6	42.9	27.6	60.8	67.9	77.2	35.1
	1955-59	2.95	3.23	9.02	16.36	2.56	4.87	35	6.5	42.9	27.9	62.4	69.2	77.5	34.4
	1956-60	3.15	2.93	8.06	13.64	2.46	4.50	4	6.5	43.1	26.1	60.2	69.2	74.7	35.0
Outerwear Knitted	1954-58	2.27	1.33	5.62	8.22	4.77	7.44	30	6.6	13.3	56.4	79.3	71.4	98.1	19.8
	1955-59	2.28	1.18	5.38	7.57	4.98	7.99	29	7.5	14.3	57.4	81.0	74.6	99.7	20.1
	1956-60	2.26	1.03	5.03	7.35	5.15	7.93	26	7.5	15.0	54.6	82.3	75.3	98.1	21.5
Overalls and Work Clothing	1954-58	3.13	1.59	4.09	5.06	3.56	4.18	36	4.3	16.2	36.7	75.2	80.4	56.3	25.7
	1955-59	3.06	1.66	5.34	6.61	3.60	4.13	37	4.4	15.8	37.5	78.8	87.9	54.2	24.5
	1956-60	3.13	1.57	5.26	6.44	3.72	4.38	35	4.4	15.6	35.9	80.2	87.6	52.5	24.5
Paints Varnishes and Lacquers	1954-58	3.41	2.26	6.37	10.73	2.59	4.51	36	6.7	33.1	25.3	46.1	66.6	70.6	22.2
	1955-59	3.31	2.61	7.43	12.07	2.62	4.64	36	6.5	32.8	26.3	46.1	67.4	71.9	20.7
	1956-60	3.33	2.71	7.95	12.61	2.66	4.76	36	7.0	32.9	26.0	45.8	66.7	71.1	20.4
Paper	1954-58	2.71	6.14	9.49	28.04	1.70	4.66	28	7.1	70.7	21.6	44.9	69.5	60.6	57.7
	1955-59	2.67	6.28	9.38	26.22	1.65	4.75	29	6.9	71.8	21.1	44.6	69.7	66.8	60.4
	1956-60	2.74	5.67	8.83	27.14	1.62	4.72	30	6.8	71.7	19.3	43.1	60.5	65.1	61.2
Paper Boxes	1954-58	2.67	4.12	10.18	23.36	2.36	5.00	27	9.6	54.5	24.8	58.4	65.0	87.7	61.6
	1955-59	2.75	3.94	9.78	22.03	2.41	6.10	27	9.6	53.9	24.4	58.0	65.7	84.9	62.6
	1956-60	2.81	3.56	8.63	20.69	2.34	5.90	28	9.5	52.0	26.3	60.3	67.0	77.4	64.3
Petroleum Integrated Corporations	1954-58	2.34	7.38	10.60	43.01	1.20	5.53	37	8.5	87.0	19.9	47.2	60.4	110.2	91.7
	1955-59	2.36	7.48	10.42	41.06	1.21	5.43	39	8.4	87.7	19.6	48.9	67.2	119.7	86.8
	1956-60	2.36	7.06	9.81	37.79	1.21	5.42	41	8.5	87.2	19.5	49.8	68.4	121.1	89.0
Printers Job	1954-58	2.37	2.53	7.45	18.54	2.64	6.88	38	*	57.3	30.9	50.1	*	*	41.2
	1955-59	2.35	2.30	7.56	19.21	2.03	7.14	38	*	56.0	30.8	52.6	*	*	43.7
	1956-60	2.35	2.12	7.03	17.04	2.63	7.14	39	*	58.8	31.1	54.8	*	*	45.3

Figure 41 (*Continued*)

Radio Parts and Supplies..	1954-58	2.24	3.25	11.44	15.97	3.20	4.74	40	5.2	38.0	54.6	87.6	81.9	95.8	31.6
	1955-59	2.34	3.43	10.88	15.94	3.06	4.54	41	5.0	37.9	47.9	83.1	82.4	89.3	29.5
	1956-60	2.38	3.64	10.81	15.57	2.95	4.46	42	4.8	38.1	47.4	79.8	83.7	85.0	29.5
Shirts, Underwear and Pajamas, Men's...........	1954-58	2.19	1.04	4.60	5.59	4.58	5.81	46	5.5	7.2	67.5	93.7	98.6	79.5	21.5
	1955-59	2.12	1.15	5.06	6.24	4.85	6.15	47	5.2	6.4	71.3	92.7	101.1	80.8	17.7
	1956-60	2.12	1.19	5.79	6.96	1.76	6.16	40	4.8	5.8	75.3	96.4	105.5	82.6	17.0
Shoes, Men's, Women's and Children's...........	1954-58	2.62	2.32	7.79	8.78	3.49	4.11	46	5.0	16.8	47.7	67.8	79.0	73.3	22.8
	1955-59	2.53	2.21	7.90	8.85	3.50	4.10	50	5.0	17.5	50.9	73.3	82.2	76.8	22.1
	1956-60	2.54	2.07	7.27	8.05	3.42	4.02	51	4.9	17.9	51.1	74.1	81.9	77.3	21.3
Soft Drinks and Carbonated Water, Bottlers..........	1954-58	1.73	5.19	11.64	35.07	2.28	7.76	15	13.2	69.7	28.7	60.7	56.4	175.9	94.1
	1955-59	1.80	5.15	12.46	41.78	2.21	8.30	15	14.1	71.0	28.1	60.1	60.8	174.5	98.5
	1956-60	1.80	5.35	11.72	41.24	2.19	9.48	16	15.6	71.5	27.2	62.4	61.0	176.6	102.7
Steel, Structural Fabricators (Sell on Short Terms)	1954-58	2.77	3.29	11.66	19.25	3.28	5.09	46	6.7	33.8	34.5	73.9	74.9	79.2	26.7
	1955-59	2.88	3.31	10.61	17.37	3.13	5.03	47	6.4	33.4	33.0	67.2	72.8	76.8	27.7
	1956-60	2.93	2.91	9.26	15.30	3.06	5.24	46	6.5	33.1	32.5	64.8	72.1	77.2	27.1
Stoves, Ranges and Ovens..	1954-58	3.45	2.01	5.48	9.60	2.80	4.33	42	5.3	31.7	30.2	54.5	74.2	59.2	26.3
	1955-59	3.47	2.32	6.36	10.30	2.92	4.42	44	5.2	30.7	29.8	56.4	73.3	59.9	24.8
	1956-60	3.55	2.03	5.79	9.07	2.88	4.37	46	5.2	29.8	28.1	59.9	71.4	57.1	23.5
WHOLESALERS															
Automobile Parts and Accessories..........	1954-58	3.13	1.79	6.30	8.65	3.40	4.54	36	5.0	14.1	37.6	65.7	86.8	57.4	18.7
	1955-59	3.02	1.88	6.82	9.26	3.40	4.51	37	4.8	13.8	39.7	67.8	88.7	57.8	19.4
	1956-60	3.01	1.89	6.72	9.20	3.35	4.37	37	4.7	13.1	39.6	69.0	87.3	57.3	19.2
Baked Goods...............	1954-58	1.85	2.25	11.29	40.84	4.68	16.58	11	23.6	72.8	29.7	54.1	77.5	146.0	99.4
	1955-59	1.89	2.33	11.56	43.28	4.68	15.88	12	26.0	74.6	29.8	54.9	72.0	162.0	95.0
	1956-60	1.87	2.24	10.94	39.41	1.36	16.49	13	25.9	74.3	28.8	52.3	71.1	164.3	85.5
Cigars, Cigarettes and Tobacco.............	1954-58	2.20	0.10	5.48	7.15	13.37	18.62	16	25.8	12.3	60.0	94.2	76.8	102.1	23.3
	1955-59	2.20	0.37	5.36	7.25	14.36	19.31	17	24.2	12.0	63.9	101.5	77.9	106.9	22.4
	1956-60	2.15	0.43	5.98	7.52	14.49	18.32	17	23.1	11.9	67.9	101.6	79.4	109.7	24.4
Drugs and Drug Sundries...	1954-58	2.49	1.84	9.19	10.80	5.32	6.70	31	7.2	12.2	59.5	74.7	90.4	70.8	19.4
	1955-59	2.50	1.81	9.23	10.90	5.43	6.73	32	7.3	13.6	59.0	76.1	90.7	71.5	19.4
	1956-60	2.57	1.72	9.05	10.54	5.39	6.48	33	7.1	13.9	57.1	76.8	89.1	72.1	20.0
Dry Goods.................	1954-58	3.08	0.87	3.52	4.31	4.00	4.76	47	6.2	4.6	39.7	62.9	68.5	66.0	17.8
	1955-59	2.95	0.89	3.71	4.45	4.19	4.96	48	6.1	4.7	43.1	64.4	70.5	68.2	17.7
	1956-60	2.94	0.86	3.61	4.42	4.21	5.07	49	6.0	4.8	44.1	65.3	72.6	68.2	16.9
Electrical Parts and Supplies.............	1954-58	2.49	1.31	6.27	7.99	5.05	6.27	42	7.3	11.2	56.1	85.2	78.6	88.8	14.5
	1955-59	2.46	1.32	6.03	7.93	5.10	6.17	44	6.9	11.0	56.7	85.7	79.1	88.6	15.5
	1956-60	2.54	1.22	5.25	7.05	5.12	6.12	42	6.7	11.8	53.1	82.5	78.8	85.1	17.1
Fruits and Produce, Fresh....................	1954-58	3.41	0.96	8.58	12.96	10.20	16.44	16	56.0	19.9	24.5	75.2	26.8	168.3	12.1
	1955-59	3.11	1.01	8.43	15.03	10.12	15.61	17	54.3	20.9	28.1	93.8	28.4	183.9	49.2
	1956-60	3.07	1.07	7.70	15.13	9.83	14.76	18	56.5	22.5	29.4	97.8	28.7	191.8	69.0
Furnishings, Men's........	1954-58	3.14	2.53	7.28	9.71	2.75	3.39	47	5.3	4.0	37.7	62.0	65.8	66.0	20.7
	1955-59	3.03	1.90	5.98	7.37	2.71	3.34	46	4.9	3.9	41.7	66.8	66.1	68.0	18.0
	1956-60	3.10	1.52	5.66	6.51	2.80	3.27	49	4.7	4.0	42.7	70.7	66.6	67.6	16.8
Gasoline, Fuel Oil, and Lubricating Oil......	1954-58	1.98	1.03	7.39	16.31	5.57	12.65	34	17.6	40.2	47.3	91.2	55.0	170.9	35.8
	1955-59	1.93	1.14	8.24	15.99	5.67	13.69	34	17.9	42.3	49.6	90.1	56.9	179.6	31.9
	1956-60	1.96	1.41	8.19	16.77	5.52	13.02	33	17.5	42.2	43.3	81.7	55.0	177.4	29.2
Groceries.................	1954-58	2.87	0.68	6.04	7.81	8.18	10.20	16	10.5	14.1	43.9	88.7	97.2	54.7	25.2
	1955-59	2.82	0.65	5.75	7.50	8.31	10.46	15	10.8	14.4	45.3	90.7	98.1	56.1	26.5
	1956-60	2.77	0.63	5.55	7.50	8.70	10.88	15	11.0	14.1	48.0	97.0	98.6	58.2	28.3

Figure 41 (Continued)

Hardware	1954 58	3 54	1 68	5.47	6.65	3 14	3 76	35	4 2	14 4	32 6	61 8	86 8	45 3	18 0
	1955 59	3 53	1 62	5.36	8 46	3.05	3 75	36	4 1	14 5	33 2	63.3	86 5	46 2	18 5
	1956 60	3 60	1 46	4 84	5.79	2 98	3.68	37	4 0	14 5	32 2	65.8	85 0	46.2	19 7
Hosiery and Underwear	1954 58	3.39	1 08	3 52	5.65	3 88	4 95	43	6 2	4 2	38.8	72 8	73 7	66.3	25 1
	1955-59	3 31	0 96	3 34	4 93	3 94	5.09	44	6 0	3.7	41 9	74 3	73 8	68 3	22 9
	1956 60	3.30	0.67	2 50	3 32	3 90	4 72	46	5.9	3 5	41 2	77 4	73 9	68 6	21 7
Household Appliances Electrical	1954 58	2 12	0 95	6 27	7 30	6 73	7 51	42	7 3	9 4	75.0	113 3	88 3	93.3	19 0
	1955-59	2 06	0.90	6 35	7 51	6 66	7 41	42	7 0	8 9	80.1	123 3	89 5	96 4	19 8
	1956 60	2 07	0 86	5.80	6.82	6.59	7 09	42	7 0	8 3	80 7	120 0	90 2	97 1	19 7
Lumber	1954 58	3 13	1 11	5.41	8.09	5 24	7 75	39	8.8	11 2	35.3	80 3	68 1	78 6	24 7
	1955-59	3 20	1 19	5 70	7 81	5.07	7 28	40	8 3	11 6	35.8	80 4	68 0	76 8	25.8
	1956-60	3 22	1 16	5.28	7 49	4 81	6 49	40	8 2	11 8	35.9	80 6	69 1	72 9	27 6
Lumber and Building Materials	1954 58	3 32	1 57	6 13	7 95	4 27	5.41	39	6 1	18 7	30 3	59 1	72 3	62 9	21 8
	1955-59	3 25	1 52	5.84	7 45	4 28	5.34	39	6 2	19 3	32 1	65 6	73 2	64 8	21 5
	1956-60	3 23	1 38	5.22	6 41	3.92	5.17	39	6 3	20 1	31 5	66.0	73 8	64 0	21 9
Meat and Poultry	1954 58	2 27	0 74	7 88	13 56	10 49	20 42	14	37 7	6.8	46 8	6 66	5.55	137 8	35.3
	1955-59	2 32	0 78	8 32	14 01	10 63	2 51	14	40 2	25.8	50 0	73 9	52 5	139 2	36.2
	1956 60	2 30	0 74	7 65	13 09	11 09	23 35	14	39 8	26.7	50.4	76 8	51 6	142 1	34 9
Paints Varnishes and Lacquers	1954 58	3.24	1 90	5.43	7 45	3 12	3 87	38	5.1	17 4	32 0	59 4	74 9	63 4	26.2
	1955-59	3 33	1 75	5 02	6 96	3 14	3 86	38	5 1	17 5	31 6	59 9	73 0	61 2	24.9
	1956 60	3 64	1 93	4 85	6 58	2 99	3.57	39	4 9	16 3	29 3	59 0	70 5	58 9	23 4
Paper	1954 58	2 80	1 12	6 09	7 36	4 99	6 57	34	7 5	11 8	45 8	81 2	77 3	79 0	17 8
	1955 59	2 76	1 14	6 42	7 64	4 98	6 56	35	7 5	11 2	47 4	81 7	78 1	78 6	18 0
	1956 60	2 80	1 15	6 38	7 71	5.03	6 43	35	7 5	10 9	47 1	83 2	78 7	78 2	17 0
Plumbing and Heating Supplies	1954 58	3 41	1 54	6 40	7 58	3 64	4 46	45	5 5	15.0	33 3	64 8	78 7	53 6	15.9
	1955-59	3 37	1 57	6 65	7 60	3 71	4 48	44	5 7	15 1	34 3	68.9	79 1	58 9	17 1
	1956 60	3 53	1 47	5.91	6 55	3 56	4 35	44	5 6	15 0	32 7	68 0	76 8	55 1	17 1
Shoes Men s Women s and Children s	1954 58	2 50	0 84	3 42	4 34	4 45	5.24	55	7 1	4 3	58 1	92 6	65.4	101 7	18 0
	1955 59	2 37	0 85	3 48	4 36	4 55	5.21	57	7 3	4 1	62 3	99 0	68 2	104 2	20 1
	1956 60	2 37	0 92	3 79	4 54	4 34	4 84	60	7 1	4 2	63 9	96 6	70 8	110 7	20 8
Wines and Liquors	1954 58	2 11	0 94	5 99	8.53	6 45	9 04	33	8.1	17 4	58 0	109 7	89 3	100 8	19 3
	1955 59	2 12	1 05	6 23	9 03	6 40	9 27	33	8.2	16 1	67 0	119 1	85 0	97 8	15.7
	1956 60	2 08	1 17	6 79	9.76	6 59	9 32	35	8 9	14 2	66 1	117 0	87 2	99 2	13 6

Figure 41 (*Continued*)

RETAILERS

Clothing, Men's and Boys'.	1954-58	3.12	2.62	5.49	7.20	2.47	3.03	†	3.5	12.4	38.8	84.8	90.2	56.1	33.3
	1955-59	2.84	2.48	5.23	6.85	2.49	3.10	†	3.5	12.8	42.8	89.4	92.2	60.2	18.2
	1956-60	2.75	2.04	4.35	5.58	2.48	3.07	†	3.5	13.4	45.3	95.2	93.2	61.5	36.4
Department Stores.........	1954-58	3.61	2.02	5.45	7.55	2.81	3.91	†	5.9	25.4	26.9	60.5	66.1	61.3	29.0
	1955-59	3.60	2.00	5.53	7.47	2.88	3.95	†	5.9	25.4	27.2	60.0	65.8	62.0	28.9
	1956-60	3.58	1.93	5.34	7.18	2.87	3.90	†	5.8	25.3	27.6	60.7	65.6	62.1	29.9
Furniture, 50 Per Cent or More, Instalment......	1954-58	3.60	2.07	4.27	4.51	1.89	2.11	161	5.0	12.2	36.4	76.0	41.7	91.8	21.0
	1955-59	3.57	1.93	4.03	4.57	1.90	2.17	162	4.8	12.0	37.7	81.0	42.3	95.1	21.6
	1956-60	3.68	1.72	3.66	4.19	1.86	2.13	164	4.6	11.0	37.4	79.1	42.1	92.3	22.0
Groceries and Meats, Independent..............	1954-58	1.82	1.07	11.59	24.37	9.83	21.53	†	17.3	55.9	49.6	86.7	128.1	87.3	56.0
	1955-59	1.81	0.97	10.66	23.83	9.58	21.16	†	17.2	54.0	50.9	91.5	128.0	91.7	60.6
	1956-60	1.78	0.99	10.84	27.51	9.56	21.81	†	19.0	52.8	48.8	84.7	126.1	97.8	67.4
Lumber and Building Materials................	1954-58	3.51	1.76	5.45	7.28	2.69	3.75	57	5.5	21.2	30.0	64.8	69.6	62.6	22.8
	1955-59	3.52	1.75	4.97	6.81	2.59	3.55	60	5.3	21.1	30.0	63.7	69.3	63.0	22.2
	1956-60	3.85	1.73	4.84	6.61	2.41	3.29	61	5.1	20.5	27.2	61.1	66.6	59.7	22.5
Shoes.....................	1954-58	2.89	1.84	6.08	8.58	3.52	4.59	†	1.0	14.6	36.5	61.8	114.0	19.5	25.3
	1955-59	2.81	1.83	6.23	8.67	3.50	4.79	†	3.9	14.4	39.5	62.8	115.7	51.2	21.5
	1956-60	2.76	1.76	6.13	8.36	3.52	5.10	†	1.0	14.1	39.4	59.8	113.6	52.4	23.1
Women's Specialty Shops...	1954-58	2.50	1.93	5.98	9.62	3.14	4.83	†	6.6	21.7	44.0	84.4	69.7	103.9	28.7
	1955-59	2.44	1.94	6.05	9.29	3.23	4.86	†	6.6	21.8	16.0	89.3	70.2	106.6	29.1
	1956-60	2.44	1.81	5.86	8.37	3.29	4.74	†	6.5	21.5	48.9	93.6	69.3	104.2	29.3

chapter VIII

DESCRIPTION OF THE INCOME STATEMENT

WHILE THE BALANCE SHEET IS THE MOST FUNDAMENTAL OF TI financial statements, complementary figures and supporting schedules a essential in credit analysis Among the most important of these compl mentary figures is the income statement This chapter will describe tl income statement, and the next chapter will outline the technique involv in interpreting it. The income statement is a schedule that shows tl income and expenses of a business enterprise over a period of time ai then gives a final figure representing the amount of profit or loss f that period[1]

In the case of a concern with a tangible net worth of $50,000 or mo there are generally two steps to be taken preparatory to analyzing t balance sheet The first step is to condense the balance sheet into few items by grouping together captions of similar significance This routi is absolutely essential for those corporations that have thirty to one hu dred items in the assets and liabilities, as it is impossible to grasp at o time the effective relationships of so many different captions No mi can apprehend a bundle of unrelated facts If, for example, a balance she contains an item 'Due from Officers" of $8,970 16 and another item "D from Employees' of $2,621 42, the combined item of $11,591 58 cou effectively be made to read 'Due from Officers and Employees," sin both items carry similar significance from the point of view of t credit analyst.

[1] Because of the varieties of accounting practice, this statement is not quite acc rate as will be seen in Chapter XI on the description and interpretation of surp accounts

The second step is to secure information about particular items which are not self-explanatory. Both of these steps have been explained in considerable detail in Chapter VII. They are generally quite unnecessary in going over the affairs of a concern which has a tangible net worth of less than $50,000, since the balance sheet of such an enterprise is generally simpler and more easily interpreted.

In a sense, the analysis of income statements is in direct contrast to the analysis of balance sheets. Whereas the balance sheet of a large enterprise must be condensed into a smaller number of related items, the income account often must be expanded, since it is frequently condensed to such a degree as to be of relatively little significance or value.

Operating managements of some corporations are often reluctant to issue publicly comprehensive operating information which they feel may be advantageous to competitors. More frequently than not, this explanation is used largely as a means to cover errors in managerial judgment which have caused losses of a definite and traceable nature.

Under the Securities Exchange Act of 1934,[2] managements of corporations with securities listed on a national stock exchange may make written objection to the public disclosure of certain information submitted in confidence to the Securities and Exchange Commission. The commission then determines whether, in its judgment, public knowledge of that information would be harmful to the continued successful operation of the business. In the majority of cases the commission has ruled against this managerial policy and has proceeded to make the information available to the public. Even when the commission consents to the concealment of data, the commercial banker can and invariably does insist, in his dealings with the larger concerns, upon receiving a complete record in the form of the annual detailed audit.

PRINCIPAL ITEMS IN THE INCOME ACCOUNT

Although each of the financial statement blanks illustrated requests an income statement, there are various degrees of concentration. A more condensed income form is included in the statement shown in the credit file, while the least condensed is in the long form for firms used by the Federal Reserve Bank of New York (Figures 31A-31D). In this blank the income account takes up approximately three quarters of an entire page. Detail breakdowns are requested for general and administrative expenses, selling expenses, other income, and other expense.

[2] Section 24.

The following six items are of primary importance in the analysis of income statements

Gross Sales

Every complete income statement starts with the amount of gross sales Both the Federal Reserve Bank of New York and the Securities and Exchange Commission forms require a separation of gross sales into sales to affiliates and sales to others—data that adds material enlightenment in the case of complicated corporate pictures

Net Sales

From gross sales are deducted returns and allowances to arrive at net sales If the percentage of returns and allowances is high, there is obviously something wrong with the merchandise produced or handled Net sales is the key figure used in computing turnover ratios in Figure 41 and in analyzing the income statement. It is the effective volume of business on which a profit is earned or a loss is assumed

Gross Profits

The third important item in the income statement is gross profits, derived by deducting the cost of goods sold from the amount of the net sales In the case of a wholesaler or a retailer, the computation is relatively simple The cost of goods sold is found by adding purchases during the period to the opening inventory and subtracting the closing inventory In the case of industrial enterprises, direct labor and manufacturing expense must also be included to arrive at the cost of goods sold

The gross profit percentage of net sales is invaluable in comparative analysis of concerns in the same line of business This ratio answers the question, "Is the mark up on cost to selling price sufficient to show a profit in a competitive world?" The average percentages of gross profits and expense items in terms of net sales are made from time to time by certain of the more progressive trade associations and by certain universities that have made financial studies for particular industries [3]

Operating Expenses

From gross profits are then deducted a series of expenses known as selling and administrative, or general, expenses These classifications cover

[3] These are mentioned in Table 51 on page 241

practically all the expenses incurred in the daily running of a business, except the cost of merchandise. Sometimes condensed into two items, expenses are at other times presented in great detail and may run to fifty or sixty items. An excessive amount in any one or several of these expenses might be the simple explanation of yearly operations in the red.

Operating Profit

Gross profit less operating expenses gives operating profit or, as it is also termed, net operating profit. In this one final mathematical figure are summed up the operating policies of the executive staff: it is the measure of the ability, skill, aggressiveness, and ingenuity of the management to operate successfully.

Net Profit or Loss

In the case of smaller business units, the operating profit is generally synonymous with net profit or loss. In the case of large business units, other adjustments must often be made before arriving at a final figure representing net profit or loss. To the operating profit in these cases there are added such credits or deducted such debits as might have arisen outside the normal operations of the business, in order to arrive at the final figure of net profit or net income for the period. These items are generally grouped under two captions, "Other Income Credits" and "Income Charges." Income credits are of wide varieties, including income on investments, royalties, and tax adjustments. Income charges may include pensions, donations, losses on securities sold, interest paid, loss on disposal of fixed assets, provisions for contingencies, and losses incurred in cancellation of leases. Operating profit plus other income and less income charges, including adjustments for carrying-back or carrying-forward of losses, and income taxes gives the final net gain or loss for the year.

INSTRUCTIONS OF SECURITIES AND EXCHANGE COMMISSION

In December 1934 the Securities and Exchange Commission issued an instruction book to assist officials of business corporations in preparing forms for the registration of securities and to provide adequate information for investors, speculators, investment counselors, labor, and the public. Subsequently amended many times, this instruction book contains several pages outlining the minimum data to be covered in preparing the income statement.

One of the anomalies of our day and age is that details filed each year with a "national" stock exchange, on which the securities of a corporation are listed, are often considerably more exacting than the information actually given to the owners of the securities in annual corporate reports Stockholders at times have difficulty obtaining operating data from managements, though the same information may be public property at the office of the Securities Exchange Commission in Washington, D C., and at the office of the stock exchange on which it is listed

The following outline of an income statement from the booklet known as Regulation S-X,[4] is divided into eighteen primary essential headings and two subheadings, but there is naturally no limitation to the amount of supporting data that the management of a business may wish to give

If income is derived from both gross sales (caption 1A below) and operating revenues (caption 1B below) the two classes may be combined in one amount if the lesser amount is not more than 10 per cent of the sum of the two items. Where these items are combined, the cost of goods sold (caption 2A below) and operating expenses (caption 2B below) may be combined in one amount.

1A *Gross sales less discounts, returns and allowances*—State separately, if practicable, (*a*) sales to parents and subsidiaries, and (*b*) sales to others

2A *Cost of goods sold*—(*a*) State the amount of cost of goods sold as regularly computed under the system of accounting followed Indicate the amount of opening and closing inventories used in the computation, and state the basis of determining such amounts (*b*) Merchandising organizations, both wholesale and retail, may include occupancy and buying costs under this caption. However, publicity costs shall be included under caption 4 below or shown separately

1B *Operating revenues*—State separately, if practicable, revenues from (*a*) parents and subsidiaries, and (*b*) others A public utility company using a uniform system of accounts or a form for annual report prescribed by Federal or State authorities, or a similar system or report, shall follow the general segregation of revenues prescribed by such system or report.

2B *Operating expenses*—State separately, if practicable, purchases from and services rendered by (*a*) parents and subsidiaries and (*b*) others A public utility company using a uniform system of accounts or a form for annual report prescribed by Federal or State authorities, or a similar system or report, may follow the general segregation of operating expenses prescribed by such system or report

3 *Other operating expenses*—State separately any material amounts not included in caption 2A or 2B above

4 *Selling, general, and administrative expenses*

5 *Provision for doubtful accounts*

6 *Other general expenses*—Include items not normally included in caption 4 above State separately any material amount

[4] The latest edition is dated August 20, 1938

Other Income

7. *Dividends.*—State separately, if practicable, the amount of dividends from (*a*) securities of affiliates, (*b*) marketable securities, and (*c*) other security investments.

8. *Interest on securities.*—State separately, if practicable, the amount of interest from (*a*) securities of affiliates, (*b*) marketable securities, and (*c*) other security investments.

9. *Profits on securities.*—Profits shall be stated net of losses. No profits on the registrant's own securities, or on those of its affiliates, shall be included under this caption. State here or in a note herein referred to the method followed in determining the cost of securities sold, *e.g.*, "average cost," "first-in, first-out," or "identified certificate."

10. *Miscellaneous other income.*—State separately any material amounts, indicating clearly the nature of the transactions out of which the items arose.

Income Deductions

11. *Interest and debt discount expense.*—State separately (*a*) interest on bonds, mortgages or similar debt; (*b*) amortization of debt discount and expense or premiums; and (*c*) other interest.

12. *Losses on securities.*—Losses shall be stated net of profits. No losses on registrant's own securities, or on those of its affiliates, shall be in included under this caption. State here or in a note herein referred to the method followed in determining cost of securities sold, *e.g.*, "average cost," "first-in, first-out," or "identified certificate."

13. *Miscellaneous income deductions.*—State separately any material amounts, indicating clearly the nature of the transactions out of which the items arose.

14. *Net income or loss before provision for taxes on income.*

15. *Provision for income and excess profits taxes.*—State separately (*a*) Federal normal income tax and surtax; (*b*) Federal excess profits tax; and (*c*) other income taxes.

16. *Net income or loss.*

17. *Special items.*—State separately and describe each item of profit and loss given recognition in the accounts, included herein pursuant to rule 5-03 (*a*) and not included in the determination of net income or loss (caption 16).

18. *Net income or loss and special items.*

TYPICAL INCOME STATEMENTS

Seven examples will be discussed to illustrate variations in income statements. Six are taken from typical annual corporate reports to stockholders, and the seventh is from the audit of a smaller, closely owned business. Starting with the condensed figures of a large corporation, which in this case are all but useless from a credit point of view, the illustrations progress step by step to income statements that are more complete and more useful.

The First Stage

Figure 42 is the condensed consolidated income account of a corporation profitably engaged for several decades in manufacturing and distributing a refined cleaning compound. It is so condensed, however, that one learns little from it but the fact that net profits for the year under review amounted to $821,675.57.

A detailed income statement, as we have seen, always begins with a figure of gross sales. From gross sales are deducted returns, allowances,

Figure 42. Condensed Consolidated Income Account*

Gross Profit on Sales	$2 540 086 45
Net Profit Before Depreciation and Income Taxes	$1 527 398 01
Deduct:	
Depreciation	88 178 29
Net Profit Before Income Taxes	$1 439 219 72
Less	
Provision for United States and Foreign Income Taxes	617 544 15
Net Profit for the Year	$ 821 675 57

* This schedule was copied from an annual report mailed to all stockholders. As the capital stock of the corporation is listed on the New York Stock Exchange, an annual report is also rendered yearly to the Securities and Exchange Commission on its more elaborate financial forms. The corresponding condensed consolidated income account rendered to the Securities and Exchange Commission even had a different initial figure, gross profits on sales being given as $2,451,908.16, instead of the $2,549,986.45 quoted above. From this gross figure were deducted selling, general and administrative expenses of $1,067,847.88, leaving net profit from operations of $1,384,060.28. Five items of other income aggregating $60,726.68 were then added, and five financial charges totaling $5,567.24 were deducted. The result was a net profit before income taxes of $1,439,219.72. From this figure were deducted estimated income taxes in the United States, Canada, and Australia of $617,544.15, leaving a net profit for the year of $821,675.57. In other words, the statements for stockholders and for the commission differed until the last three items.

and discounts to arrive at net sales, the key figure in judging the merchandising ability and aggressiveness of the management and the demand for the product. A horizontal trend analysis of net sales and a comparison of this company's trends with those of other concerns in the industry would indicate its relative progress or decline.

The condensed income statement above fails to show the successive expense deductions, such as the cost of raw material, salaries, wages, selling expense, rent, advertising, insurance, interest, bad debts, office supplies,

light, heat, water, and depreciation. This schedule might be compared to an attempt to give an outline of the history of ships and shipping in one sentence, of commerce and trade in a single paragraph, of the human race in one page. In this example the only items of expense about which one learns anything are that (1) depreciation for the year amounted to $88,178.29 and (2) provision for United States and foreign income taxes amounted to $617,544.15—a limited amount of enlightening data, to say the least.

The Second Stage

There is a well-known corporation that has been engaged in manufacturing pyroxylin and acetate plastics for many years. In its annual report appears the condensed consolidated profit and loss account in Figure 43, which is only slightly more enlightening than the first illustration:

Figure 43 Condensed Consolidated Profit and Loss Account

Profit from Operations, Before Depreciation		$385,541.32
Add:		
Other Income.	$133,400.38	
Less Miscellaneous Charges	117,624.76	15,775.62
Net Income Before Depreciation and Contingencies . . .		$401,316.94
Less:		
Provision for Depreciation Accrued	$190,355.38	
Provision for Contingencies.	28,107.79	218,463.17
Net Income for the Year.		$182,853.77

Here again no figures are available for gross sales, returns, allowances, discounts, net sales, and selling and administration expenses. Where the first concern gave two items of expense, this account, however, gives three: (1) miscellaneous charges of $117,624.76, (2) provision for depreciation accrued of $190,355.38, and (3) provision for contingencies of $28,107.79. Whether the net income is before or after taxes is a mystery. The item called "Miscellaneous Charges" is hardly more useful to a credit or financial analyst than more snow is to an Eskimo. "Provision for Depreciation" can have only one interpretation, but the mere title "Provision for Contingencies" fails to tell what the contingencies are and how they arose.

This statement is, indeed, a "condensed" consolidated profit and loss account and of little real use to a banker. The corporation has none of

its securities listed on a stock exchange and has sold no securities to the public, so stockholders might actually have no source of information outside of the annual corporate report. If a loan to this concern were outstanding or if one were being requested, the capable banker would insist upon obtaining for immediate study and then file away for future reference the detailed audit, which would show the exact amount of net sales and the important grouping of expense items with supporting breakdowns. That would be absolutely essential. And he would also seek and obtain an explanation of each of the three charges and the one of credit, which appear in the quoted statement, as well as of any other items in the full profit and loss account in the detailed audit that might not be self-explanatory.

The Third Stage

The third income statement contains no more items of expense than the first two, but it has the advantage of quoting an item of gross sales and services, less discounts, returns, and allowances. This key figure of the net volume of business handled during the year is required for any thorough analysis. Although the operating managements of many large corporations are reluctant to quote net sales in annual reports to stockholders, the public is certainly entitled to this essential information before being asked to risk its savings in enterprises characterized by a complete divorce between ownership and management.

Figure 44 is the consolidated statement of income of an enterprise engaged in the manufacture of typewriters, adding machines, filing cabinets, billing machines, and similar office equipment. Notwithstanding the slight improvement in quoting gross sales and services, less discounts, returns, and allowances, this statement is woefully inadequate for credit analysis.

After the initial figure of gross sales and services, less discounts, returns, and allowances, there appears the typical "condensed" schedule. The second figure is simply net profits for the year before depreciation and Federal taxes. To arrive at this figure, all charges such as cost of raw materials, manufacturing, selling and administrative expenses, advertising, rent, interest—in fact, every charge except the two that are next mentioned in the schedule, depreciation and Federal taxes—are lumped together in one grand sum and deducted from the sales figures. No competitor, stockholder, security analyst, or banker would have any basis for deciding whether any single item of expense might or might not be out of reasonable proportion.

From this net result figure are deducted depreciation and the provision for Federal taxes to give a net income of $2,238,704.04 for the year. Before passing on an application for credit from such an enterprise, the loan officer would request a copy of the detailed audit. He would be interested in learning how much of the first item of $27,312,196.65 represented sales of merchandise and how much services, what the exact figures were for discounts and allowances on both items, and also the amount of returns

Figure 44 Consolidated Statement of Income*

Gross Sales and Services—less discounts, returns, and allowances		$27,312,196.65
Net results of Operations for the Year—after deducting manufacturing, selling, and general expenses and all other charges, but before depreciation and Federal taxes on income; including net operating results of wholly owned non-consolidated subsidiary companies		$ 4,766,886.48
Deduct:		
Depreciation	$ 483,182.44	
Provision for Federal taxes on income	2,045,000.00	
Net income for the year		$ 2,238,704.04

* This consolidated income account as of the same date filed with the Securities and Exchange Commission was slightly more elaborate but contained little more essential information. The first figure of gross sales and services, less discounts, returns, and allowances was the same at $27,312,196.65. From this figure there were then deducted two items: cost of goods sold and services, selling, general, and administrative expenses of $23,280,325.14, and provisions for doubtful accounts of $191,597.91, giving a figure which had no title in the schedule of $3,840,273.60. To this amount were added two items of income and deducted provisions for Federal income taxes to give the final net income of $2,238,704.04. Unlike the income statement in the annual corporate report, the one filed with the Securities and Exchange Commission was a continuous schedule. There were only three identical items in the two schedules: the first and last figures and the one for Federal taxes of $2,045,000. The schedule filed with the Securities and Exchange Commission did, however, contain eight explanatory footnotes which would have been of infinite assistance in understanding and analyzing these figures. The income statement in the annual corporate report contained no such footnotes.

on the merchandise sales. He would also desire to know the cost of goods sold, gross profits on sales, and how the difference between the gross sales and the so-called "net results" of $4,766,886.48—the very representative sum of $22,545,310.17—was used; that is, how much for raw material and how much for the various broad items of operating expense, manufacturing, selling, and administration.

These first three income statements are typical of hundreds that appear each year in the annual corporate reports of corporations with widely

distributed stock interests and in all lines of commercial and industrial activity The information is condensed and grouped under one, two, or three headings that are so broad that they have little or no significance This condensation is a distinct handicap to anyone attempting to make a basic analysis of the operating costs

The Fourth Stage

Somewhat more information can be gleaned from the consolidated income and expense statement in Figure 45 of the fourth corporation and

Figure 45 Consolidated Income and Expense*

Sales		$667 138 391 08
Cost of Sales		546 038 448 79
Gross Profit		$121 099 942 29
Add.		
Interest and Miscellaneous Income		2 758 241 84
Total Income		$123 858 184 13
Deduct		
Administrative Engineering Selling advertising		
Service and General Expenses	$47 657 402 19	
Interest Paid	90 238 97	47 747 641 16
Profit Before Provision for Taxes		$ 76 110 542 97
Provision for Federal and State Income		
Taxes	$32 800 000 00	
Provision for Foreign Income Taxes	1 200 000 00	34 000 000 00
Net Profits for the Year		$ 42 110 542 97

Note Depreciation and amortization in the amount of $14 211 151 76 have been charged to cost and sales and expenses

* The consolidated income statement submitted to the Securities and Exchange Commission by this corporation showed a rearrangement of the items and a break down of four of them into more enlightening subdivisions (*a*) administrative, en gineering selling, advertising service and general expense of $47,657,402 19 was broken down into three figures, (*b*) interest and miscellaneous income of $2 758 241.84, into four figures (*c*) interest paid of $90 238.97 into two figures and (*d*) provision for *Federal, state, and foreign income taxes of $34,000,000 into two figures*

its subsidiaries, a vast system engaged in the successful production and distribution of automobiles

The real advances in this statement over the three previously examined are the figures on (1) cost of sales, (2) gross profit, and (3) interest paid, and (4) a footnote stating the amount of depreciation and amortization charged to cost of sales and expense There remains, however, quite a representative item of $47,657,402 19 into which is generously lumped such current expenses as administration, engineering, sales, advertising,

service, and general expense. Though each of these six items must be broken down into many component parts on the books of the corporation for daily scrutiny by the executive staff, they are thoroughly obscured from the view of investors and creditors.

As of the date of its statement, this corporation was in a particularly strong financial condition, and any depository approached for a loan would have regarded the request with real favor. A final net profit of \$42,110,542.97 is indeed something to write home about. It is indicative of skillful business management even in an improving market. The method of grouping expense items in this statement is, however, often followed by corporations that are not in such strong financial condition. Though a long step ahead of the income statements already examined, this statement obviously might be broken down into still greater detail. Unquestionably the executives of this corporation would readily give additional information to the banker.

The Fifth Stage

Additional information of a rather specialized character, owing to the possession of extensive real estate and leasehold holdings, is shown in the consolidated income statement in Figure 46 of a corporation and its subsidiaries that operate several successful retail stores and also a string of mills, which produce part of its merchandise requirements.

This concern was incorporated in 1901 as successor to a business founded in 1865. Its history, except in recent years, has been one of outstanding commercial aggressiveness and success. For the year under review, an aggregate volume of \$104,204,936.63 was transacted in both the manufacturing and the retail divisions. Several years ago a substantial peak was reached with a volume of \$179,659,000. As a result of the unprofitable handling of many lines of merchandise, the manufacturing division has recently lost money, while the retail stores have shown net profits.

This consolidated income account gives appreciably more information than does any one of the four operating statements previously quoted. All of the items, however, are quite substantial. Interest on the funded debt, including amortization of bond discount, aggregated \$1,135,028.84, in contrast to the moderate figure of \$90,238.97 in the fourth income statement on page 223.

All of the other expense items, except one, are concerned with real estate, such as lease charges, depreciation, real estate and property taxes, and

occupational taxes Four separate and distinct items of this nature have been segregated so that expenses incidental to real estate operations will not be confused with the great variety of normal expenses in operating retail department stores and mills The total expenses for the normal operation of the business are grouped together under a single caption and amount to $94 016,293 46 This is quite a respectable sum The schedule would obviously have been somewhat improved if the cost of goods

Figure 46 Consolidated Income Statement

Net Sales to Customers		$104 204 936 63
Rental Income from Tenants		1 930 755 94
Total Net Sales and Rentals		$106 135 692 57
Cost of Sales and Operating Expenses		
Cost of Sales and Operating Expenses Exclusive of Items Listed Below	$94 016 293 46	
Rentals Paid under Ground and Building Leases	1 668 557 15	
Provision for Depreciation of Buildings and Equipment and Amortization of Leaseholds	2 377 467 60	
Real Estate Personal Property and Franchise Taxes etc	2 101 701 62	
Occupation Taxes	1 657 898 49	101 821 918 32
Net Profit Before Interest and Federal and State Income Taxes		$ 4 313 774 25
Interest Charges and Federal and State Income Taxes		
Interest on Funded Debt (including amortization of bond discount)	$ 1 135 028 84	
Provision for Federal and State Income Taxes	1 300 000 00	2 435 028 84
Net Profit for the Year		$ 1 878 745 41

sold had been segregated This was emphasized in the report made to the Securities and Exchange Commission, which does contain such an item, amounting to $81,305,814 74

So, when all is said and done, although this income statement does contain a greater amount of desirable information, it would have been still more enlightening if this one oversized item had been broken down into a limited number of parts, at least showing cost of merchandise sold, gross profits, selling expenses, and administrative expenses In addition, no full understanding of the operating picture of this concern could be made without three supplemental operating schedules one showing the detailed exact expense of the retail division of the business, one for the manufacturing division, and one for the real estate division Three such

supplementary schedules would indicate the presence or absence of profits in the various divisions of the corporation. Finally, any banker digging into affairs more closely would need even the individual operating accounts of each retail store and mill. Facts are the only secret of intelligent financial analysis.

The Sixth Stage

The comparative consolidated income statement in Figure 47, included in the annual report to the stockholders of a brimstone producer, is a

Figure 47 Comparative Consolidated Income Account

	Year Before Last	Last Year
Gross Sales	$9,787,232.73	$12,043,048.55
Less:		
Freight and Handling	941,367.98	1,044,403.38
Net Sales.	$8,845,864.75	$10,998,645.17
Cost of goods Sold—Exclusive of depreciation and depletion deducted below.	6,106,641.50	7,364,270.49
Gross Profit on Sales	$2,739,223.25	$ 3,634,374.68
Administrative, Selling, and General Expenses.	599,646.89	640,151.29
Net Profit on Sales	$2,139,576.36	$ 2,994,223.39
Other Income.	10,203.17	65,572.19
Total Income.	$2,149,779.53	$ 3,059,795.58
Net Income of Parent Company and Minor Subsidiaries Before Depreciation Deducted Below	33,341.93	24,510.45
Net Income Before Depreciation, Depletion and Income, and Capital Stock Taxes	$2,183,121.46	$ 3,084,306.03
Provision for:		
Depreciation and Depletion	$ 541,012.90	$ 596,337.24
Federal and State Income and Federal Capital Stock Taxes	150,000.00	275,000.00
Foreign Taxes	....	12,000.00
	$ 691,012.90	$ 883,337.24
Net Income.	$1,492,108.56	$ 2,200,968.79
Proportion of Loss of C-A-M Corporation and Subsidiaries Applicable to Stock Held By the Subject Company	64,910.03	191,185.22
Final Net Income.	$1,427,198.53	$ 2,009,783.57

positive improvement over the preceding cases. Not only does it contain more items than the income accounts already examined and so naturally provides additional enlightenment, but the figures are set up in a most

progressive manner so that a comparison may be made at a glance with the corresponding items of expense for the previous year Comparative schedules for two or more years are extremely desirable and an increasing number of annual corporate reports have followed this style during recent years

Here we have a noticeably more complete income statement The schedule begins with an item of gross sales, from which is deducted freight and handling to arrive at net sales Then follows the largest single item of expense, a sum into which is lumped a substantial portion of the costs for mining, refining, and producing sulphur, and which amounts to $7,364,270.49 for the last fiscal period and $6,106,641 50 for the one before that. Net sales less these costs give the gross profits on sales

From the gross profits is deducted one lump sum representing administration, selling, and general expenses Two other items of income are then added From the sum are deducted the following charges (1) depreciation and depletion, which should always be separated to judge of their adequacy, (2) Federal and state income and Federal capital stock taxes, and (3) foreign taxes Finally, one further technical charge is made, representing proportionate losses of the C-A-M Corporation and subsidiaries applicable to stock held by the subject company

The Seventh Stage

The income statements thus far have been of nationally known corporations Perhaps that is one of the fundamental reasons for the varying degrees of concentration in the information The statement in Figure 48, is of a much smaller enterprise, with a tangible net worth in the neighborhood of $145,000 This concern operates a chain of eight retail stores in the Middle West, handling a popular priced line of women's ready-to-wear, *consisting principally of suits, coats, dresses, hosiery, and silk under*wear This schedule was not prepared for the operating management to release to its stockholders, but for the officers, who are also the sole owners of the business, and for bank creditors The details into which the expense items are broken down are in marked contrast to the income statements already examined

This particular schedule contains all of the main subdivisions described in the early part of this chapter It starts with a beginning figure of net sales amounting to $1,417,451 58 Sales are made entirely on a cash basis, so there is no item of gross sales and no items of discounts and allowances to be deducted to arrive at net sales Then follows a brief computation

arriving at the cost of goods sold amounting to $999,320.86, the difference with the net sales giving the gross profits on sales of $418,130.72. This sum represents 29.5 per cent of the net sales, a favorable proportion. From this sum are then deducted the various items of operating expense and credits and such income as is received in addition to the sale of merchandise. These debits and credits come under five broad headings: "Store Expenses," "Store Income," "Home Office Income," "Home Office Expenses," and "Other Home Office Deductions."

Figure 48 Income Statement for Retail Stores Inc. (*year ended December 31, 19–*) (*page 1*)

Net Sales			$1,417,451.58
Cost of Sales:			
Inventory at Beginning		$ 68,433.36	
Purchases		1,033,142.54	
Total		$1,101,575.90	
Less Inventory at End		102,255.04	
Cost of Sales			999,320.86
Gross Profits on Sales			$ 418,130.72
Store Expenses:			
Rents	$133,355.93		
Managers' Salaries	44,527.46		
Managers' Bonuses	9,083.56		
Selling Salaries	66,475.38		
Non-Selling Salaries	29,719.68		
Advertising	33,773.32		
Signs and Display	5,454.06		
Light and Heat	23,778.27		
Freight and Expressage	19,833.50		
Wrapping Materials	4,728.82		
Telephone and Telegraph	2,902.74		
Postage	3,360.39		
Repairs	17,775.32		
Stationery and Supplies	4,744.49		
Traveling Expenses	1,507.44		
Bad Checks	136.69		
Legal and Professional Fees	2,846.35		
Miscellaneous Expenses	4,207.76		
Taxes	10,423.47		
Insurance	4,432.61		
Depreciation	7,723.28		
Cleaning	1,086.93		
District Manager's Salaries and Expenses	9,600.74		
Unemployment Insurance Taxes	1,666.51		
Total Store Expenses		$443,144.70	
Store Income:			
Rent Received from Shoe Department	$ 30,359.59		
Rent Received from Millinery Department	30,859.66		
Rent Income	4,020.00		
Shortages and Overages	314.51		
Total Store Income		65,553.76	
Net Store Expenses			$ 377,590.94
Net Store Profit			$ 40,539.78

The unusual feature of this schedule, however, is the great variety of individual items under these five headings For instance, to arrive at the final figure of store expense of $443,144 70, there are twenty-four individual items ranging from rent of $133,355 93 and managers' salaries of $44,527.46 down to bad checks of $136 69 and a cost of wrapping materials of $4,728 82 Then come four credit items under 'Store Income" and two under "Home Office Income," the largest of which is discount on purchases of $96,574 74

Figure 48 (*Continued—page 2*)

Home Office Income		
Discount on Purchases	$96 574 74	
Miscellaneous Income	1 466 96	
Total Home Office Income		$ 98 041 70
Total Profit		138 581 48
Home Office Expenses		
Salary—David Jones	$15 000 00	
Ralph Jones	10 000 00	
Executives	6 683 34	
Buyers	14 951 18	
General Office	9 428 07	
Shipping and Receiving	3 185 19	
Advertising	3 140 00	
Rent	3 999 96	
Light and Heat	475 10	
Telephone and Telegraph	2 330 80	
Traveling Expenses	8 422 92	
Stationery and Supplies	1 895 23	
Expressage	1 664 24	
Legal and Auditing	5 166 87	
Manager in Training	866 55	
Advertising	1 019 45	
Sh pping Materials	1 565 83	
Postage	1 566 39	
Cleaning	312 25	
Insurance	628 30	
Depreciation	424 51	
Protection	219 00	
Miscellaneous Expenses	3 456 95	
Repairs	224 51	
Storage	284 90	
Taxes	874 15	
Bonuses	6 401 60	
Unemployment Insurance	750 25	
District Manager	2 939 55	
Convention Expense	225 00	
Total Home Office Expenses		$ 108 102 09
Operating Profit		$ 30 479 39
Other Home Office Deductions		
Shortages in Shipments	$ 79 23	
Home Office Mark Downs	2 491 41	
		2,570 64
Net Profit for the Period		$ 27 908 75

"Home Office Expenses," like "Store Expenses," is made up of a large number of individual items, thirty charges coming together under this heading and aggregating $108,102.09. The largest items are naturally salaries; the smaller items, postage, cleaning, protection, repairs, storage, and convention expenses. The principal stockholder of this business makes it a consistent practice each year to take every item of expense into the income account, to determine the percentage of net sales that each item represents and then to compare the results with the corresponding percentages for the preceding year. Any item that shows a material increase in its percentage on net sales during the year is then carefully and diligently analyzed to ascertain why the increase took place. Naturally such careful supervision keeps the management in touch with every single expenditure, and the monetary saving in the course of a year is appreciable.

After the deduction of the total of home office expenses comes the figure giving the operating profit for the year of $30,479.39. Two adjustments are then made—shortage in shipments of $79.23 and home office mark-downs of $2,491.41, amounting together to $2,570.64—and deducted, leaving the final net profit for the year of $27,908.75. There is no item of Federal income tax, as the corporation had a carry-forward loss from the previous year. An income statement in such detail cannot help but be of greater value to the loaning officer of a bank than any so-called "condensed" figures. For bank credit purposes figures can never be obtained in too great detail. Statements may always be condensed, when considered desirable, by the analyst himself.

chapter IX

THE INCOME STATEMENT

THE INCOME STATEMENT IS THE MATHEMATICAL EXPRESSION OF the policies, experience, knowledge, foresight, and aggressiveness of the management. The final net profit or loss is the ultimate measure of the skill of the active management. A time always comes when a concern that is taking continuous losses must lock both the front and rear doors and disappear from the field of active economic competition It would thus be most unusual if a banker were not more favorably disposed toward the enterprise with the better operating record, even though the net profit figure by itself has only a moderate bearing upon the temporary, but for the moment the exact, financial soundness of a commercial or industrial business enterprise

Where a banker has obtained neither an income statement nor a reconciliation of surplus, both progress and decline are at times easily concealed An increase in surplus might be due not to earnings, but to the sale of additional stock or to the write up of certain assets. Conversely, a reduction in surplus might result not from an operating loss, but from dividends or withdrawals in excess of earnings, a downward revaluation of assets, or miscellaneous charges made through the surplus account. These adjustments are considered in the next chapter on the description and interpretation of the surplus account

MANIPULATION OF PROFIT FIGURES

The comprehensive volume *Security Analysis* contains seven chapters on "Analysis of the Income Account."[1] This "analysis," however, is only

[1] Benjamin Graham and David L. Dodd, *Security Analysis* (3rd ed, New York McGraw Hill Book Co., Inc., 1951), chaps 9–15

nominally concerned with variations in the expense items and their relations to net sales. The primary objective of the analysis is to acquaint the reader with those artifices and window-dressing devices designed to misrepresent earnings and to conceal losses.

Because of the lack of standard practice in handling the intricate problems involved in corporate accounting, "there are unbounded opportunities for shrewd detective work, for critical comparisons, for discovering and pointing out a state of affairs quite different from that indicated" by audited figures. Every stockholder, investor, and speculator should realize *that earnings are subject "in extraordinary degree* to arbitrary determination and manipulation." The two devices that are commonly used for this purpose and are of the utmost importance to the banker, are:

1. Making charges to the surplus account, instead of to income, or vice versa.

2. Overstating or understating depreciation, depletion, amortization, and other reserve charges.

Charges to Surplus

Chapter X discusses the apparent leeway allowed managements to decide whether certain nonrecurrent charges should be made to current operations through the income statement or should be made as adjustments to the surplus account. This device greatly affects the amount of the reported net profits.

Overstatements and Understatements

Overstatements and understatements of depreciation, depletion, and reserves for other purposes, such as future losses and contingencies, are more easily understood as a manipulation device, but not so easily noticed, except in a most comprehensive study. To decide whether a particular charge for depreciation or depletion is adequate is often a matter of technical knowledge after the information has finally been obtained. This knowledge is more likely to be part and parcel of the equipment of the industrial engineer than of the banker. What the banker can and must at least do is to observe any changes from past policies. Both the New York Stock Exchange and the Securities and Exchange Commission have insisted that any changes in accounting practices or charges of which these are the more important items, must be made known to stockholders. Obviously, whenever depreciation charges are overstated or understated, reported net earnings are correspondingly distorted.

Earnings may be classified by source, as "Operating Income," "Income from Outside Operations," and "Other Income" The last two classifications refer to sources outside the principal activity of a business. "Income from Outside Operations" may, for example, include the profitable operation of a hotel by a railroad company, while "Other Income" would include income on investments and from rent. While net income from all sources is the measure of managerial capacity, earnings from operations are usually more stable than income from other sources Hence, in analyzing the earning power of an enterprise, the analyst studies the proportion of income from each source A satisfactory margin of operating profit, as the income from regular operations is called, does not always signify a satisfactory earnings position

The fact that a profit or a loss was assumed by the sale of a piece of unnecessary real estate or a factory, or a charge-off on bad debts which occurred two years ago, is just as much a credit or a charge against the judgment and the efficiency of the management as the sale of unit products on a high gross margin of profit When, furthermore, a concern has an *operating profit* of $50 000 and suffers a loss of $75,000 on an investment in a bankrupt subsidiary, there is a *net loss* of $25,000 for the year A business enterprise may conceivably show operating profits each year for a number of years, retain all of the profits in the business, but subsequently become bankrupt through unfortunate extracurricular activity

Six Items of Importance in the Income Statement

As described in the previous chapter, the six significant items in the income statement are gross and net sales, gross, operating, and net profit, and operating expenses For convenience in interpretation, these same items may be divided into two groups of primary and secondary information

The primary information consists of net sales, gross profits, and net profits

Net Sales—Net sales is the key figure in the income statement and must be known for computing the turnover of inventory, of net working capital, and of tangible net worth and the average collection period—ratios that we have found essential for understanding the inherent soundness of a balance sheet. Net sales is also essential in the so-called sales analysis, a process by which an analyst estimates, on the basis of average monthly sales, the time required by an enterprise to liquidate its liabilities and whether payments might be slow in the immediate future

Gross Profit.—The percentage of gross profit on net sales indicates to the experienced banker whether the average mark-up on merchandise sold is sufficient normally to cover all expenses and to show a profit. If a particular retailer of paints and varnishes with annual sales of $285,000 operates on a gross profit margin of 26.5 per cent and suffers a net loss, the reason for the loss may easily be traced. The typical gross margin of profit in this line is around 35 per cent on net sales, and the concern under investigation was operating on an inadequate mark-up. A certain margin of gross profit is essential for every line of commercial and industrial activity. This margin varies moderately with the volume of net sales, the size of the city or town in which the enterprise is located, the intensity of competition, and the terms of sale, but normally should be sufficient to cover expenses and reasonable profit.

Net Profit.—The amount of net profit and of dividend disbursements or withdrawals is of interest to the banker as measures of managerial capacity and conservatism in dividend policy. Since assets depreciate, operating expenses mount, and contingencies arise, inadequate earnings or excessive dividend payments may eventually destroy a sound asset structure as shown by the balance sheet. Despite the importance of profitability, however, the banker should look primarily to the turnover of receivables and merchandise and the current position generally in judging the immediate credit position of a business enterprise.

The information of secondary importance shown in a fairly complete income statement includes: gross sales, operating expenses, and operating profit.

Gross Sales.—Gross sales exceeds net sales by the amount of discounts, returns, and allowances and is of significance for revealing these charges. The extent of returns and allowances is an indication of whether the merchandise produced or handled is meeting the reasonable requirements of customers. If merchandise is sold under false colors—if paper cover stock, for instance, is sold green instead of having been dried out properly—the high returns and allowances may indicate dissatisfaction on the part of customers. Similarly, if a mechanical pencil is defective, returns will likewise be out of all reasonable proportion and will involve unexpected expenses in replacements or repairs or both. Excessive returns and allowances thus greatly reduce the receipts from given sales, and may also curtail the volume of sales. Improper control over returns and allowances may quickly convert profitable into unprofitable operations.

Operating Expenses.—A banker, like any budget director, has a deep interest in seeing that expenses are kept within proper bounds. Poor

management which has become involved in paying excessive rents, burdensome interest charges, heavy traveling expenses, and exorbitant entertainment costs has brought many businesses to an untimely demise In many lines of business, standards for these particular expenses have been determined and are used as a basis for study and comparison by progressive managements and bankers

Operating Profit—The operating profit is the sum available after all normal operating charges, but before discounts received or given, income from investments, taxes or miscellaneous credits, and debits not actually incurred in operations This figure is the measure of the ability of the management to carry on the daily operations profitably Some managements are able to show an adequate profit up to this point, but then seem to fail in supplementary policies, which result in changing the operating profit into a materially smaller net profit or even a final net loss Both the operating profit and the final net profit are necessary in determining the financial results from different phases of management operation

COMPARATIVE ANALYSIS

Income statements, like balance sheets, are of the greatest value when obtained over successive periods of time and so present comparative data at periodic intervals All bank comparative statement forms (illustrated in Chapter VII) have lines on which net sales, net profits, and dividends or withdrawals may be inserted, so that this information may be seen currently whenever the balance sheet is being studied An increasing number of the larger central reserve city banks use full-page comparative forms for income accounts as extensively as comparative balance sheet forms

The comparative analysis of balance sheets consists in comparing the fluctuations in the amounts represented by individual items in successive financial statements *Similarly, successive income statements are set up* in parallel vertical columns, and explanations of important changes in individual items are obtained The changes may be set down in other columns in absolute numbers, as horizontal percentages of the corresponding items in selected base years, or as vertical percentages of the particular year's net sales

Comparative Figures of Hosiery Manufacturer

Reference to the comparative income statements in Figure 49 of a manufacturer of ladies' full-fashioned nylon hosiery shows the respective

items for the two years set up for a comparison. The amounts for a particular item are on the same horizontal line for each of the two years. One glance shows an increase in sales, a sharper increase in selling expenses, and the conversion of a net loss into a net profit.

Figure 49 Comparative Income Statements of Hosiery Manufacturer

	B Year Before Last	A Last Year	Per Cent to Net Sales Year B	 Year A
Gross Sales	$1,992,453.85	$2,007,859.91		
Less returns, allowances and discounts	19,383.30	31,561.73		
Net Sales	$1,973,070.55	$1,976,298.18	100.00	100.00
Cost of Goods Sold.	1,873,341.83	1,689,854.11	94.95	85.51
Gross Profit	$ 99,728.72	$ 286,444.07	5.05	14.49
Expenses:				
Selling	$ 64,538.14	$ 78,270.42	3.27	3.96
Administrative and general	40,042.15	39,475.43	2.02	1.99
Total Expenses.	$ 104,580.29	$ 117,745.85	5.29	5.95
Operating Profit or Loss .	(L)$ 4,851.57	$ 168,698.22	(L).24	8.54
Add Other Income:				
Interest earned.	1,155.99	109.71	.06	.01
Dividends on securities owned	1,070.23	. . . . . .	.05	. . . .
Recoveries on accounts charged off	193.41	864.27	.01	.04
Rentals	3,708.16	1,683.86	.19	.08
Miscellaneous sales	6,331.68	4,603.75	.32	.22
	$ 7,607.90	$ 175,959.81	.39	8.89
Less Other Deductions:				
Interest on notes payable. .	11,745.25	32,015.06	.59	1.61
Allowance for losses on miscellaneous accounts. .	. . . . . .	3,635.91	. . . .	.18
Profit or Loss Before Bond Expense	(L)$ 4,137.35	$ 140,308.84	(L).20	7.10
Bond Interest and Expense:				
Interest on bonds	$ 21,160.00	$ 38,570.00	1.07	1.95
Amortization of bond discount and expense . . .	5,466.60	5,466.60	.27	.27
	$ 26,626.60	$ 44,036.60	1.34	2.22
Net Profit or Loss.	(L)$ 30,763.95	$ 96,272.24	(L)1.54	4.88

Following the two columns of dollar figures are two columns of percentages, in which each of the original items is expressed as a percentage of the particular year's net sales. These percentage figures, whether expressed vertically or horizontally, facilitate comparison. Of outstanding note in this example is the 9.44 reduction in cost of goods sold as reflected

in the higher gross profit. The loss in year B was accounted for by the purchase of a substantial amount of raw material during a rising market in the belief that prices would continue to rise. The market dropped instead, and the concern took a 1.54 per cent loss on sales in liquidating the high priced inventory.

As a result of this lesson the management made every effort to keep costs down in year A. Merchandise purchases were kept in close relation to the purchase budget, machines were run for longer periods, direct labor costs were kept in hand, and the final result was a most satisfactory gross profit of 14.49 per cent on net sales.

The only other material change in these comparative statements was the rise of selling costs from 3.27 per cent to 3.96 per cent. When questioned about this increase, the management explained that an effort had been made to increase sales to individual retail stores. As the increased selling effort became effective and business was developed with new outlets sales to chain stores and mail order houses, where the gross mark up was hardly sufficient to break even, were moderately reduced. The change in policy worked out satisfactorily during the year and accounted partly for the increase in gross margin. These interesting statements show the decided effect of revamped manufacturing and distributing policies upon the profits of a business.

Comparative Figures of Dry Goods Wholesaler

The comparative income statements for the wholesaler of dry goods in Figure 50 discloses a much smaller annual volume of business than the previous statements of the manufacturer of ladies' nylon hosiery. Moreover, as this enterprise is a wholesale business, there are no labor expenses in the cost of goods sold. In year B a loss of 0.49 per cent on the net sales was sustained as contrasted with a profit of 4.77 per cent in year A. How account for this change?

Through an improvement in operating and buying technique the cost of goods sold decreased from 84.93 to 83.05 per cent, bringing about a somewhat more favorable increase of 1.88 per cent in the gross profits on sales. At the same time selling expenses decreased from 12.55 per cent to 8.49 per cent. Selling expenses tend to increase so gradually as almost to be undetected by managements. Also there is a tendency on the part of officials to exert less stringent control over expenses incurred in getting business than over most general and administrative expenses.

This concern is the exception that proved the rule. Its products were

the leaders in their field, well priced and attractively packaged. Moreover, the greater portion of the net sales was handled by the president of the corporation himself, and he received a modest salary and no commission. The greater the volume he handled, the less was paid out in

Figure 50 Comparative Income Statements of Dry Goods Wholesaler

	B Year Before Last	A Last Year	Per Cent to Net Sales Year B	 Year A
Sales:				
Charge	$201,809.45	$216,061.76		
Cash	10,323.88	10,697.84		
Total	$212,133.33	$226,759.60		
Less Returns and Allowances	6,737.46	7,007.16		
Net Sales	$205,395.87	$219,752.44	100.00	100.00
Cost of Sales:				
Merchandise Inventory, Jan 1	$ 24,462.23	$ 23,678.61		
Purchases	172,807.41	206,134.19		
Express In	368.82	333.49		
	$197,638.46	$230,146.29		
Less Merchandise Inventory, Dec 31.	23,205.05	47,649.47		
Cost of Goods Sold.	$174,433.41	$182,496.82	84.93	83.05
Gross Profit	30,962.46	37,255.62	15.07	16.95
Less Selling Expenses				
Commissions and Salaries .	$ 15,662.62	$ 11,953.86	7.62	5.44
Express Out	1,672.47	1,051.34	.82	.48
Light and Heat	590.99	383.29	.28	.17
Paper and Twine	488.06	348.53	.24	.15
Salaries — Officers	3,800.00	2,800.00	1.85	1.28
Advertising.	403.78	160.74	.19	.07
Rent.	3,170.43	1,975.73	1.55	.90
Total Selling Expenses . .	$ 25,788.36	$ 18,673.49	12.55	8.49
Net Profit Before Selling and Administrative Expenses.	5,174.10	18,582.13	2.52	8.46
Less General and Administrative Expenses:				
Salaries of Officers	$ 2,115.54	$ 2,411.26	1.03	1.11
Insurance.	647.02	794.05	.32	.37
Postage.	231.20	397.91	.12	.19
Depreciation on Furniture and Fixtures	258.18	258.47	.13	.13
Depreciation on Leasehold Improvements	340.95	762.99	.17	.35
Stationery and Printing. . .	178.93	269.12	.08	.13
Professional Service. . . .	219.77	312.38	.10	.14
Telephone Service	305.23	496.64	.15	.15
Salary.	1,500.00	2,000.00	.73	.93
General Expenses	372.65	398.73	.18	.19
Total	$ 6,169.47	$ 8,101.55	3.01	3.69
Net Profit or Loss	(L) $ 995.37	10,480.58	(L) .49	4.77

commissions to others. This is reflected in the decrease in salaries and commissions from 7.62 per cent to 5.44 per cent during this two-year period. In the face of increased sales, every other item in the selling expenses was likewise reduced. This achievement certainly indicated excel-

lent control, close personal management, and real aggressiveness Express out, light and heat, paper and twine, salaries of officers, advertising, and rent—each item of selling expenses showed a reduction, which, though moderate, was sufficient to turn a loss into a profit

A small part of the funds saved in selling expenses was used in increased general and administrative expenses, but only a small part These expenses expanded from 3 01 to 3 69 per cent In other words, the slightly larger gross profit on sales and the material reduction in selling expenses made it possible for this enterprise to have a very successful year

Recapitulation

The manufacturer of nylon hosiery improved its operations by reducing its cost of goods sold to a reasonable level The wholesaler of dry goods turned a loss into a profit partly by reducing the cost of goods sold and partly—this is more important—by reducing certain operating costs, which in this case were selling expenses Information of this nature may often be obtained by a careful study of comparative income statements, which disclose, in the increase and in the decrease of important items of expense, the secret of the fluctuation in operating results Often final losses are the result of an excessive increase in salaries of officers, of lavish expenditures for entertainment, of top-heavy charges to depreciation Likewise, in many cases final profits are recorded after a reduction of these same items of expense

INTERNAL ANALYSIS

In the comparative analysis of income statements, important upward or downward changes in dollars and in percentages are investigated and studied to ascertain their causes In an internal analysis of an income statement, all items are expressed as percentages of net sales Each percentage is then compared with some predetermined base to ascertain whether particular items of expense are heavy, about normal, or light Such an analysis is predicated on the assumption that if any particular item of expense is abnormally large, the net profit will be proportionately smaller

In an internal analysis, for example, each percentage in the statement in Figure 49 would have been compared with a standard or average income statement for a manufacturer of ladies' nylon hosiery handling an annual volume of business of approximately $2,000,000 This comparison would have immediately disclosed the fact that the principal

item out of line in year B was the cost of goods sold at 94.95 per cent. With a gross margin of only 5.05 per cent to cover all other costs of operations, it was no more possible to earn a profit than to run an automobile without fuel. The margin had to be increased. All other items of expense were very moderate. If the cost of goods sold could be decreased from 7 to 10 per cent, bringing the gross margin of profit somewhere between 12 to 15 per cent, operations would again be profitable. That is exactly what was brought about in the following year A.

A somewhat different situation would have been apparent in an examination of the statements of the wholesaler of dry goods in Figure 50. The gross profit percentage here was ample, though slightly increased in year A. Through reducing all individual items in the selling expenses materially and at the same time increasing the volume of net sales, however, the management was able to produce a final net profit.

Standard or average percentage costs have been made available for sales groups of various sizes in particular lines of industry and commerce by trade associations, universities, and business enterprises interested in studying the operating records of these lines. Similar studies have been made by Dun & Bradstreet, Inc., from time to time. In order to make such a study both more valuable and more useful to the banker and the businessman, the retail stores in those lines of business surveyed by Dun & Bradstreet, Inc., have been broken down into geographical subdivisions showing the typical net sales per store in New England, the Middle Atlantic states, the East North Central states, the South Atlantic states, the East South Central states, and the West South Central states.

In Figure 51 on page 242 there is a summary of the typical percentages of operating costs for forty-one lines of retail and service trade. This schedule indicates the differences in typical costs of goods sold, typical gross margins, and general overhead expenses for various divisions of the retail and service trades, and the effect that a slight variance in expense percentages might have upon the final net profits of an individual business enterprise.

Figure 51 Operating Ratios for Forty-One Lines of Retail Trade

RETAIL TRADE	Year	Cost of Goods Sold (per cent)	Gross Margin (per cent)	Total Expense (per cent)	Net Operating Profit (per cent)	Selected Operating Expenses: Owners' Compensation (per cent)	Employees' Wages (per cent)	Occupancy (per cent)	Advertising (per cent)	Bad Debts (per cent)	Inventory Turnover Per Year (times)	SOURCE OF SURVEY
Appliance Radio-Television Dealers	1958	64.5	35.5	34.4	1.1	3.1	15.0	2.5	2.8	0.7	4.6	National Appliance and Radio-TV Dealers Association, 1141 Merchandise Mart, Chicago 54, Ill.
Auto Accessory and Parts Stores	1955	65.6	34.4	31.7	2.7	10.5	9.8	4.7	1.2	0.1	3.9	Dun & Bradstreet, Inc., New York, N. Y.
Auto Dealers	1958	85.1	14.9	14.7	0.2	— 7.5V —		1.2	0.8	**	**	National Automobile Dealers Association, 2000 K Street N.W., Washington 6, D. C.
Bakeries	1955	58.1	41.9	38.3	3.6	10.6	11.3*	6.1	0.6	**	18.7	Dun & Bradstreet, Inc., New York, N. Y.
Bars and Taverns	1953	54.2	45.8	43.4	2.4	10.9	15.5	6.8	0.7	**	13.5	Dun & Bradstreet, Inc., New York, N. Y.
Book Stores	1954	61.9	38.1	35.1	3.0	9.2	6.9	6.7	1.7	**	3.3	American Booksellers Association, Inc., 175 Fifth Ave., New York 10, N. Y.
Camera and Photographic Supply Stores	1954	69.1	30.9	28.5	2.4	9.8	6.7	4.8	1.9	0.0	3.2	Dun & Bradstreet, Inc., New York, N. Y.
Candy Nut and Confectionery Stores	1955	64.2	35.8	35.4	0.4	13.9	6.3*	8.5	0.5	**	11.8	Dun & Bradstreet, Inc., New York, N. Y.
Children's and Infants' Wear Stores	1957	67.5	32.5	30.8	1.7	9.4	7.2	6.9	1.2	0.0	2.6	Dun & Bradstreet, Inc., New York, N. Y.
Department Stores#	1958	68.1	31.9	31.3	0.6	— 18.3 —		2.9	1.7	0.2	2.5	Bureau of Business Research Bulletin No. 155, Harvard University Graduate School of Business Administration, Soldiers Field 63, Boston, Mass.
Drug Stores	1958	65.3	34.7	29.5	5.2	8.0	11.2	2.2R	**	**	3.8	Eli Lilly and Company, Indianapolis 6, Ind.
Dry Goods and General Merchandise Stores	1957	70.5	29.5	27.6	1.9	8.6	8.6	4.5	1.5	0.0	2.4	Dun & Bradstreet, Inc., New York, N. Y.
Family Clothing Stores	1956	69.4	30.6	27.9	2.7	9.4	7.7	4.2	1.5	0.0	2.3	Dun & Bradstreet, Inc., New York, N. Y.
Farm Equipment Dealers	1958	82.5	17.5	14.2	3.3	2.2†	4.3*	*	0.6	0.2	2.8	National Retail Farm Equipment Association, 2340 Hampton, St. Louis 10, Mo.
Farm Supply Stores	1956	84.1	15.9	14.4	1.5	4.2	4.8	1.6	0.5	0.1	14.2	Dun & Bradstreet, Inc., New York, N. Y.
Floor Covering Stores	1954	64.3	35.7	34.0	1.7	9.0	12.4	4.3	1.8	0.0	3.7	Dun & Bradstreet, Inc., New York, N. Y.
Florists	1953	52.6	47.4	44.1	3.3	12.6	11.7	7.0	1.8	0.1	11.8	Dun & Bradstreet, Inc., New York, N. Y.
Furniture Stores#	1958	61.6	38.4	37.9	0.5	— 21.0 —		6.2	5.2	1.0	2.6	National Retail Furniture Association, 666 Lake Shore Dr., Chicago 11, Ill.
Gasoline Service Stations	1956	76.8	23.2	22.1	1.1	6.5	9.1	4.0	0.5	0.0	21.3	Dun & Bradstreet, Inc., New York, N. Y.
Gift, Novelty and Souvenir Stores	1957	60.0	40.0	38.1	1.9	13.8	7.0	8.7	1.2		2.4	Dun & Bradstreet, Inc., New York, N. Y.
Grocery Stores	1952	84.1	15.9	14.4	1.5	6.0	3.9	2.7	0.1	0.0	13.6	Dun & Bradstreet, Inc., New York, N. Y.
Grocery and Meat Stores	1950	83.7	16.3	14.3	2.0	3.7	3.4	1.9	0.4	**	17.2	Dun & Bradstreet, Inc., New York, N. Y.
Hardware Stores	1958	69.5	30.5	29.5	1.0	8.1†	10.6	3.7	1.6	0.2	2.0	National Retail Hardware Association, 964 North Pennsylvania St., Indianapolis 4, Ind.
Jewelry Stores (Cash and Open Credit)	1953	55.6	44.4	40.7	3.7	15.3	8.9	7.4	2.2	0.0	1.2	Dun & Bradstreet, Inc., New York, N. Y.
Jewelry Stores (Installment Credit)	1953	52.5	47.5	41.7	5.8	10.1	12.3	6.9	3.4	1.7	1.4	Dun & Bradstreet, Inc., New York, N. Y.
Juvenile Furniture Stores	1954	66.6	33.4	30.2	3.2	10.0	6.1	6.8	2.6	0.0	3.4	Dun & Bradstreet, Inc., New York, N. Y.
Liquor Stores (Package)	1955	80.3	19.7	17.1	2.6	7.6	2.9	2.9	0.5	**	5.9	Dun & Bradstreet, Inc., New York, N. Y.
Lumber Dealers	1955	75.5	24.5	21.1	3.4	5.5	8.7	1.8	0.7	0.3	4.3	Dun & Bradstreet, Inc., New York, N. Y.
Meat Markets	1954	79.3	20.7	19.3	1.4	6.8	6.4	2.3	0.2	0.0	53.3	Dun & Bradstreet, Inc., New York, N. Y.
Men's Furnishings Stores	1952	67.2	32.8	29.3	3.5	9.8	6.5	6.4	1.5	0.0	2.1	Dun & Bradstreet, Inc., New York, N. Y.
Men's Wear Stores	1958	65.5	34.5X	32.1X	2.3X	7.0	11.0	2.9R	2.5	0.3	2.4	New York University on Grant from MEN'S WEAR MAGAZINE, 7 E. 12th St., New York, N. Y., July 24, 1959
Music Stores	1956	64.2	35.8	33.3	2.5	9.6	9.2	5.2	2.1	0.0	3.0	Dun & Bradstreet, Inc., New York, N. Y.
Office Supply and Equipment Dealers	1958	64.7	35.3	32.8	2.5	4.3†	18.5	8.0	1.2	0.2	3.0	National Stationery and Office Equipment Association, 740 Investment Bldg., Washington 5, D. C.
Paint and Wallpaper Stores	1956	66.9	33.1	30.1	3.0	11.4	6.9	4.9	1.4	0.2	3.2	Dun & Bradstreet, Inc., New York, N. Y.
Restaurants	1950	52.7	47.3	44.0	3.3	7.9	21.8	6.7	0.5	**	35.5	Dun & Bradstreet, Inc., New York, N. Y.
Shoe Stores (Family)	1958	63.1	36.9	33.1	3.8	10.1†	8.5	4.0R	2.9	**	2.0	Washington University, St. Louis, on Grant from MEN'S WEAR MAGAZINE, 7 E. 12th St., New York, N. Y., July 24, 1959
Sporting Goods Stores	1953	71.4	28.6	26.6	2.0	9.3	5.4	5.1	1.7	0.0	2.5	Dun & Bradstreet, Inc., New York, N. Y.
Toy Dealers	1958	64.2	35.8	24.3S	11.4S	0.0S	8.2	7.8	2.7	**	3.1	PLAYTHINGS Magazine, 71 W. 23rd St., New York 10, N. Y.
Women's Accessory and Specialty Stores	1954	66.8	33.7	31.5	2.2	11.2	5.8	7.5	1.0	0.0	2.6	Dun & Bradstreet, Inc., New York, N. Y.
Women's Ready-to-Wear Stores	1955	67.7	32.3	29.4	2.9	8.3	8.8	5.4	1.2	0.0	4.1	Dun & Bradstreet, Inc., New York, N. Y.
Women's Wear Stores#	1958	64.5	35.5	31.5	1.0	— 18.6 —		3.8	2.6	0.3	4.5	Bureau of Business Research Bulletin No. 155, Harvard University Graduate School of Business Administration, Soldiers Field 63, Boston, Mass.

The bracketed ratios are based on net sales.

* Does not include manufacturing labor. ** Not available. R Rent only. † Salaries of owners and managers. X—Total expense plus net profit does not equal gross margin. V—Does not include mechanics' wages. S—Before owners' salaries were drawn. # Ratios shown are for stores in the following volume groups: department stores with annual sales volume under $250,000; furniture stores, between $250,000 and $500,000; women's wear stores, under $250,000.

chapter X

THE SURPLUS ACCOUNT

THE LAST ITEM IN THE BALANCE SHEET OF A CORPORATION BEFORE the total of aggregate liabilities is the surplus account.[1] This is one of the conventions of American accountancy, which is fixed about as firmly as the orbit of Jupiter.

Occasionally there are two surplus accounts: capital surplus and earned surplus. The capital surplus at times is also termed "paid-in surplus." The earned surplus more recently has also been termed "retained earnings." In these cases "Earned Surplus" invariably is the last item in the balance sheet. The earned surplus account should represent actual earnings retained by a corporation over and above dividend disbursements. As a result of operating losses, this account may represent a deficit or an impairment of capital. The distinction between earned and capital surplus is important, since ordinarily only the former should be made available for dividend payments.

CAPITAL SURPLUS

When a corporation is distributing securities to the public, the management at times has the fixed assets reappraised by an appraisal company. In this process, fixed assets that previously had been carried at $200,000 might now be carried on the books at $350,000. This increase, known as a "write-up," is represented by a new item called "Capital Surplus," rather than by an increase in earned surplus, since no sale has been consummated.

Often these reappraisals are made during periods of high prices, and

[1] With the rather rare exception where a business enterprise sets up an item of "Undivided Profits" like a banking institution. In these cases the undivided profits are really a segregated portion of the surplus account.

years later, when prices have fallen, the reappraised values represent very inflated figures This procedure in financial strategy is brought out for the purpose of emphasizing the fact that the tangible net worth of a business is sometimes an inflated figure, particularly when an item of capital surplus appears Chapter VII, covering the relationships of balance sheet items, should be reviewed to judge of the conservatism in valuing property assets and their relation to the tangible net worth of a commercial or industrial business enterprise

An item of capital surplus may also be created by the sale of capital stock at a price in excess of its par value, or, if no par stock is issued, in excess of its value as given in the books of the corporation, that is, if a corporation sells 100,000 shares of no par stock at $10 per share, but carries the stock on its books at $5 per share, the difference of $500 000 would normally be treated as capital surplus

Capital surplus may arise from the following sources

1 Donations, which usually take the form of treasury stock

2 Amount by which stock is sold in excess of book value, or no-par stock in excess of the value for which it is carried in the balance sheet.

3 Upward revaluation of assets In many states, payment of dividends from the resulting surplus constitutes a criminal offense

4 Reduction of liabilities at a discount

5 Closing out of special reserves no longer required Whether such reserves should be closed into earned or capital surplus must be judged in the light of the particular circumstances

The analyst must therefore, always ascertain whether an item of capital surplus was created from some arbitrary bookkeeping or accounting procedure or from the investment of additional cash in the business

Reappraisals may write down as well as write up fixed asset values In a depression, fixed assets valued at $350,000, for example, may be written down to $200,000 in recognition of values forever lost and gone The $150,000 loss will then be charged against capital surplus already available or created by recapitalization The recapitalization may take the form of a reduction in par value of par value stock, change from par to no-par stock, reduction in the stated value of no par stock, or piecing-together of shares Any of these means makes available a capital surplus against which to write off losses Finally, such devaluations may be charged against current income, if substantial or in the event no capital surplus is available

When asking for an explanation of a sudden substantial increase in surplus, the banker may occasionally learn that the fixed assets have been

written up by a reappraisal and the increase added without earmark to the earned surplus account. This accounting practice is misleading, is rarely countenanced by independent accountants, and under no consideration would be allowed by the Securities and Exchange Commission.[2] A reconciliation of the surplus would reveal the source of the credit to surplus as being a mark-up of fixed assets rather than actual earnings.

In Figure 52 surplus account of a corporation distinguishes between earned and capital surplus and further classifies the latter as revaluation

Figure 52 Surplus Account of a Corporation

Capital Surplus:	
March 31, 19— Excess of Revalued Assets over Liabilities and Capital Stock	$1,677,887.48
Excess of Sales Prices of 115,060 shares of Capital and Treasury Stock over its Par Value	300,569.10
Issued for Property—60,003 Common Stock-Purchase Warrants at $1.00 per Warrant	60,003.00
Capital Surplus on December 31, 19—	$2,038,459.58
Earned Surplus since March 31, 19—	$ 550,517.59

surplus, premiums on sale of capital stock, and proceeds from the sale of stock-purchase warrants. In this schedule the capital surplus is carried at $2,038,459.58, and the earned surplus at $550,517.59, which is only slightly more than one fourth as large.

The sources of capital and earned surplus should be carefully investigated by the banker who hopes to estimate the asset value of a business with any degree of accuracy and to detect attempts at both overstatement and understatement of invested capital and earning power.

RECONCILIATION OF SURPLUS ACCOUNTS

The earned surplus account in any two successive balance sheets of the same concern is represented by two different figures. During the interval

[2] The first release by the Securities and Exchange Commission, known as *Accounting Series Release No. 1* and dated April 1, 1937, was concerned with the propriety of making charges to earned surplus and capital surplus. This problem subsequently arose in the consideration of the accounting practices used by a well-known corporation and probably reached its apogee in the spectacular report of the commission on the Alleghany Corporation, dated March 1, 1940: "The net effect of failing to apply proper accounting principles . . . can be well illustrated by reviewing the surplus accounts for the year ended December 31, 1934. Whereas the balance sheet originally filed indicated that earned surplus amounted to $2,296,581.28 and paid-in surplus was $4,752,773.38 the statements after amendment reveal an earned surplus deficit of $52,641,439.19 and a paid-in surplus of $35,990,444.70."

covered by the dates of the two balance sheets the surplus will have increased or decreased The schedule of surplus credits and debits between these two dates is termed the "Reconciliation of Surplus", in the case of proprietorships or partnerships, it is known as the "Reconciliation of Net Worth" The first figure in the schedule is the amount of surplus in the initial balance sheet. The profits during the period and miscellaneous credit adjustments serve to increase the opening balance Withdrawals, dividends, and surplus charges are deducted, and the balance is the surplus as shown in the more recent balance sheet. What credits or charges should be made to surplus are determined by the management of the business and its accountants

At the present time there is a marked trend toward the use of a combined income statement and earned surplus Such a combined statement meets a dilemma that constantly confronts the accountant. Over the years it is plainly desirable that all costs, expenses, and losses of a business, other than those arising directly from its capital-stock transactions, be charged against income[3] If this principle could in practice be carried out perfectly, there would be no charges against earned surplus except for distributions and appropriations of final net income The combined statement minimizes the chances of overlooking charges made to earned surplus[4]

The reconciliation of surplus in the vast majority of cases is simple, it generally involves very few items, so that the schedule is easily understood In fact, in the typical simplified instance only two of three items are involved a credit of profit from operations and a deduction for losses, withdrawals, or dividends. A reconciliation of surplus becomes complicated only when various and miscellaneous credits and debits appear in the statements of larger corporations Three surplus reconciliation statements will be presented in the order of their increasing complexity in order to illustrate the practical effect of such miscellaneous charges upon earning figures from a fundamental credit point of view These complications rarely occur, except in the statements of large corporations

The First Degree of Complexity

In the simplest example of the three, Figure 53, six figures are involved One of these is the sum of two items, while another is the difference of

[3] See p 217

[4] *Restatement and Revision of Accounting Research Bulletins, Accounting Research Bulletin*, No 43 (New York American Institute of Certified Public Accountants, 1953), pp 17–18

other figures. In this schedule the net income of $1,143,774.29 for the fiscal year was added to the earned surplus, which at the beginning of the year amounted to $1,314,732.01. From this total of $2,458,506.30 was then deducted all of the dividends declared and paid during the fiscal year, $71,627.50 on the 5 per cent cumulative preferred stock and

Figure 53 Surplus Reconciliation Statement I

Earned Surplus, balance at the beginning of the year	$1,314,732.01
Net Income, year ending Oct. 31, 19—	1,143,774.29
	$2,458,506.30
Deduct:	
5 per cent cumulative preferred dividends	71,627.50
Common dividends	673,923.25
Earned Surplus, balance at the end of the year	$1,712,955.55

$673,923.25 on the common stock, leaving an earned surplus which was carried in the last balance sheet at $1,712,955.55. This reconciliation of surplus could be simpler only if no dividends had been paid. In that event the simple addition of the net income for the year to the beginning surplus would have given the surplus at the end of the fiscal year.

The Second Degree of Complexity

The second example of surplus reconciliation in Figure 54 begins to show some mild modifications on the simplified formula above. In addition to both the credit to surplus of the profits for the year and the debit of the dividend disbursements, three items of expense have also been

Figure 54 Surplus Reconciliation Statement II

Earned Surplus at the beginning of the year		$224,824.55
Add: Net profit for the year		351,673.20
		$576,497.75
Deduct:		
Dividends	$211,819.32	
Expenses in connection with reclassification of preferred stock	13,434.68	
Additional expenses in connection with the exchange and sale of 4 1/4% debentures in preceding year	4,592.25	
Premium on 4 1/2% debentures purchased for retirement through sinking fund.	380.00	
		$230,226.25
Earned Surplus at the end of the Year.		$346,271.50

charged to the surplus account. The accounting basis for charging these items to the surplus account will be discussed later

In this case the year started off with an earned surplus account of $224,824.55 Operations were conducted on a splendid margin of profit, and $351,673 20 was added to the earned surplus, giving the substantial figure of $576,497 75 From this sum were then deducted aggregate dividends of $211,819 32 Up to this point, this particular reconciliation of surplus is similar to the one already quoted. Now, however, we begin to find a material difference Three items were charged not to the income statement but to the earned surplus account expenses amounting to $13,434 68, in connection with the reclassification of preferred stock, additional expenses of $4,592 25, in connection with the exchange and sale of 4¼ per cent debentures in the preceding year, and a premium of $380 on 4¼ per cent debentures purchased for retirement through the sinking fund These three items together came to $18,406 93 They are a type of charge often termed "extraordinary and non recurrent," as they are not incurred in the normal daily operations of a business and supposedly will not recur in the following year

If these three extraordinary items had been charged to the income statement and not to the earned surplus, the second figure in this schedule, representing net profit for the year, would have been $333,266 27 and not $351,673 20 The difference would have been 5 2 per cent less than the amount reported In other words, by the very simple expedient of charging the surplus account, net profits for the year may be inflated and thus mislead the analyst unless he is on his guard.

The Third Degree of Complexity

In the third classification of surplus reconciliation statements in Figure 55, the policy pursued in the second surplus account is developed to an exaggerated degree A wide variety of charges are made directly to the surplus account, with consequent possible inflation of reported earnings. In addition to the normal debit for dividend disbursements, five other charges appear in the following surplus reconciliation statement.

To an initial earned surplus of $299,558 were added the impressive net profits of $713,138 72 for the year From that total was deducted a series of seven items, of which the two most important were dividends on preferred stock of $44,445 57 and dividends on common stock of $564,048 15 The remaining five items ranged from charges amounting to $47,088 24 for the retirement of fixed assets and charges of $38,032 19

for adjustments in reserves for depreciation to expenses of $9,757.24 in connection with financing not consummated—making the respectable sum of $127,849.61. If these five charges had been made to profit and loss, as many accountants would conservatively recommend, net profits would have been 17.9 per cent less than the amount actually reported to stockholders.

Figure 55 Surplus Reconciliation Statement III

Earned Surplus at the beginning of the year.		$ 299,558.00
Add: Net profit for the year		713,138.72
		$1,012,696.72
Deduct:		
Dividends paid on preferred stock	$ 44,445.57	
Dividends paid on common stock	564,048.15	
Expenses in connection with distribution of dividends on common stock	12,972.94	
Adjustment of reserves for depreciation as of January 1, 19—	38,032.19	
Reserve provided for investment in Reserve Corporation	19,999.00	
Charges resulting from retirement of fixed assets	47,088.24	
Expenses in connection with financing not consummated	9,757.24	
		$ 736,343.33
Earned Surplus at the end of the year.		$ 276,353.39

These charges were all actual expenses incurred in operating the business, and the fact they were segregated from other operating charges might indicate a desire on the part of the management to show larger profits than somewhat more conservative accounting practices would have shown. No matter what the policy is or its theoretical basis, there is no doubt about the real effect.

NET PROFITS

It is not particularly difficult to determine the net profits of a small retail business enterprise. With some semblance of book records and a physical inventory at the beginning and close of the fiscal year, the net profit before dividends or withdrawals is represented by the difference in the excess of the value of all of the assets over the liabilities between the two dates. If exact bookkeeping records are maintained, the net profit may also be determined by deducting successively from gross income the cost of goods sold, salaries, wages, rent, light, heat, telephone, taxes, and

all other expenses of the business Any amount left over before dividends or withdrawals represents the net profit The formula is simple, widely used, readily understood, universally and almost intuitively known No matter what the items of expense are or how they occurred, they are deducted one and all before arriving at a residue to represent the final net profit

The same process is used by small or moderate-sized manufacturing enterprises The only change, in the case of manufacturers, is the addition of direct labor, depreciation on machinery, and other factory charges to the list of expenses already mentioned This formula for computing net profit is probably used by "99 44 per cent" of the business enterprises of the country

When we study the financial condition and operating records of concerns with distributed stock interests—that is, corporations with capital securities listed or traded on some stock exchange or over the counter—there is occasionally a vital modification to this simple, everyday, practical accounting convention This modification is the quarantining of certain items of expense, carefully keeping them away from income statement, but turning them over body and soul to the ubiquitous surplus account That is what happened in the two surplus accounts on pages 247 and 249

Charges to Surplus

Sometime during the first quarter of this century this practice was theoretically justified on the basis that an income statement should be concerned fundamentally not with including all items of expense, but with showing the net profit *from operation for the year*, unaffected by losses and adjustments applicable to other years In other words, two arbitrary tests were created to determine whether an item of expense constituted a charge against current operations

1 Was the expenditure for normal operations?
2 Was it incurred or accrued during the year under review?

Under this theory, charges and credits of a special and non-recurrent nature are made by some accountants to surplus The application of this theory to the accounting practices of nationally known industrial and commercial corporations has naturally resulted in many unusual situations Thus, a profit or loss incurred by the sale of fixed assets, charges for carrying a manufacturing plant not in actual use, profits or losses incurred in the sale of securities, charges to wipe out underwriting costs, tax refunds or additional taxes, so-called "extraordinary write-downs" to

inventory and receivables—one and all might be made to profit or loss or to surplus depending on the point of view of the operating management, or on a compromise between the views of the management and the accountants if outside independent accountants are on the books and making the audit. In the examples already quoted in this chapter, such items as expenses in connection with the reclassification of preferred stock, additional expenses in connection with the exchange and sale of debentures, expenses in connection with the distribution of dividends on common stock, and adjustment in reserves for depreciation never found their way to expense, but were charged to earned surplus.

In view of the complexities introduced by surplus adjustments and the fact that the classification of income and surplus charges is often based on the whims of the management, the banker must be on guard against manipulations designed either to overstate or to understate earnings. Probably the least justification exists for making such charge to the surplus account as write-downs on inventories and on receivables when the design is to have the charge missed from year to year and never applied to the income statements.

Credits to Surplus

Although the three surplus accounts that have been quoted do not contain credits from extraordinary items of this nature, such credits are made from time to time. Credits to surplus are rarer than debits, but for consistency must be made. When, for example, a corporation has been putting charges for additional taxes through the surplus account, any unusual tax rebate must logically be credited to surplus. If a loss on the sale of a capital asset were charged to surplus, it would be only logical to credit a profit on the sale of capital assets. One exception to the general practice of adjusting profit and loss figures occurs when an asset that was once arbitrarily written up is now written down. Where both the write-up and the write-down are book entries, they should not appear in the income statement.

The accounting policies of managements are sometimes designed to minimize reported profits in good years and to enhance reported profits in poor years. They may be motivated by a desire to avoid public criticism and a clamor for dividends when earnings are high, as well as to conceal an impaired position in poor years. In more recent years corporations have made fewer adjustments through the surplus account and more directly against current operations. The improved earnings might partly account for this fact.

Adjusting Reported Net Profits

From a credit point of view, we are primarily and fundamentally interested in ascertaining the amount of net profits after all charges, whether the charges are made to the income statement or to the surplus account. Net profit is the one final measure of the ability of the management to operate a business enterprise successfully, and it must take into consideration all of the policies of the management If the president of one company is able to show a net profit of $50,000 from operations and then loses $50,000 by poor investment policies, he would certainly need more careful watching than the management that earned the same profit and was able to keep a firm grasp upon those funds A similar situation would be created if a management showed an operating profit of $20,000, but that sum was offset by a write-down in inventory of the same amount. Such a management would need more careful watching than one that earned the same profit and had no write-down on inventory

The last figure in the income statement, therefore, should never be accepted unequivocally as the absolute net profit or loss until the surplus account has been carefully scrutinized and taken into account.

MISCELLANEOUS CHARGES

A study of the income statements and of the surplus accounts of borderline and questionable credit risks, to ascertain the amount and the extent of individual expenses, often solves crucial operating policies by bringing to light those places where the management has unnecessarily lost money through poor judgment If substantial write-downs are taken on inventory or on receivables, something must be wrong with the purchasing or credit policy Often detection of the ailment in the income statement or surplus account will suggest the remedy

Extraordinary and non recurrent charges should invariably be segregated and analyzed individually Frequently the analyst will find that the manufacturing and distributing operations have been carried on intelligently and profitably, but the final results have been unsatisfactory because of unprofitable outside operations, such as losses assumed in financing a subsidiary or extraordinary sums spent fruitlessly on research The goal of maximum net profit will be more nearly approached by learning and then correcting the causes for losses in the income statement and the surplus reconciliation account which are out of line with sound management policies

chapter XI

BUSINESS BUDGETS

WITH THE EXTENSIVE PUBLIC DISCUSSION OF THE FEDERAL BUDGET each year, the term "budget" is no longer a word of mystery, nor does it conjure up the great leather bag in which the early English chancellors of the Exchequer carried their financial documents.

Moreover, since the widespread advent of the instalment method of purchase, there has been a steady development of what have been called "budget plans." Any one may obtain a budget plan showing how much of his weekly or monthly income should be spent for rent, food, clothing, entertainment, travel, and savings. Whether the individual is single, married and without offspring, or with one, two, or three children, his budget will indicate the amount of the weekly or monthly income that may be disbursed per week or month for the purchase of an automobile, a piano, television, chair, sofa, vacuum cleaner, diamond ring, or suit of clothes. Furthermore, any life insurance salesman with a little experience is prepared to suggest, with unquestioned authority and without the loss of a single breath, how much money to allow out of any salary for the purchase of life insurance; and if life insurance salesmen themselves do not always agree upon the same figure, at least the minimum amount is always and without exception sufficiently large.

While business budgets are generally more complicated than personal budgets, they are of no less interest and benefit to debtor and creditor alike.

DESCRIPTION OF BUSINESS BUDGETS

In the fully developed budget system of large manufacturing corporations, there are no less than fifteen major budgets: the sales budget, which is the starting point of budgeting; the production budget, which is the

basis for manufacturing and cost control, the budgets for raw materials, incidental materials, indirect materials, and supplies, the purchase budget, which helps promote judicious buying, the labor budget, the manufacturing expense budgets, financial budget, master budget, estimated balance sheet, and estimated income statement. This is quite an array of budgets

Budget Figures of Interest to the Banker

The intricacies and details of complete budgeting for a large manufacturing establishment are certainly vast Of the fifteen major budgets, however, only two are of material interest and concern to the credit department or to the loaning officer of a bank For him they are the essence, the concise summary, the sum and substance of budgeting These two schedules consist of (1) a consecutive series of estimated balance sheets, and (2) a consecutive series of estimated income statements

Occasionally the important information from these two instruments is condensed into a single brief schedule to give a concise summary of operating expenses and results and at the same time the working capital position of an enterprise This latter single schedule is the more simple and the more easily grasped, but if grouped expenses are high and actual costs exceed budgeted figures, then one must refer to underlying expense figures to ascertain which items are out of line The details are invariably available, however in the full income statement and the full balance sheet Examples of the use of the detailed balance sheet and the detailed income statement, and of the condensed combined hybrid schedule of these two instruments will be discussed in this chapter from the point of view of the loaning banker

Just as an experienced, capable credit analyst, without full knowledge of the technique of accounting, is trained in interpreting financial statements in a more fundamental manner than the typical accountant, so here in the field of budgeting no technical knowledge is required to interpret the various budgets set up to estimate and control operating results

Budget Figures and Sales Forecast

The typical balance sheet and income statement received by the banker from a depositor, prospective account, or concern under investigation for some other reason, are designed to reflect the financial condition of the concern as of a date already passed These figures then represent a financial condition that, after mature consideration, is to be maintained or

improved during the following month, quarter, or other period. All budget schedules, however, represent plans based upon forecasts or estimates for the future. These forecasts and estimates must, however, be sound.

The fundamental budget forecast is a sales forecast—that is, a prediction based upon all available information, knowledge, and research as to the volume of business a concern might reasonably expect to handle during each of the ensuing twelve months, individually and cumulatively by months. This forecast might be based upon a rough estimate or upon an elaborate study "into the nature, character, and quality of a product or products, trends in the use of the product or products, relative opportunity for sales in different geographical areas, relative merits of different methods of promotion and sales, effect of price upon volume of sales, prospective business and economic conditions and their probable effect upon different methods of promotion and sales."[1] In other words, an estimated income statement which contains a forecast of all operating income and expenses in great detail is drawn up for each month of the coming year and for the year as a whole. A tentative balance sheet is also prepared showing the financial condition of the business as of the end of each month, on the assumption that actual operations will work out exactly as planned in the estimates of sales, production, income, and expense.

Estimated Monthly Figures

By this process the financial condition at the end of one fiscal year may be compared with the estimated condition at the end of each month in the ensuing year, and necessary changes may be made in operating policies to reach predetermined logical objectives. The budget thus establishes in advance the objective of operations for any period and provides a monthly basis for comparing estimates and results. If the estimated profits are not being approximately realized from month to month, then an intelligent study of the figures will always indicate where changes should be made in operating policies, in order to attain or more nearly approach the objective by the end of the current fiscal year. The budget fundamentally is a management device to anticipate income and expense as well as the financial condition of a business between fiscal dates.

The typical procedure on the part of the operating management is to

[1] John H. Williams, *The Flexible Budget* (New York: McGraw-Hill Book Co., Inc., 1934), p. 5.

draw up both yearly and successive monthly budgets The yearly budget enters into few details, but gives a comprehensive summary of the anticipated income from all sources and of the anticipated expenditures from all sources with a final net profit or loss, also the balance sheet to be anticipated at the end of the fiscal year The yearly budget is supplemented and controlled by the various monthly budgets, which go into as much detail as is required by the nature of the business and which make due allowances for seasonal and month by-month fluctuations in sales, income, and expense which take place in every business enterprise The month by month budgets are checked at the end of each month against the actual results for the month The causes of discrepancies are then noted and analyzed, and whenever necessary, changes are immediately made in operating policies to bring the trend of results, if possible, more into line

Often wholly unexpected circumstances arise during the year that necessitate the discarding of previous estimates and forecasts and the revision of monthly budgets for the remainder of the fiscal year Especially is this true during periods characterized by sharp fluctuations in prices or business activity and by strikes or other episodic movements During periods of uncertainty both forecasts and budgets must necessarily be for short periods because of the difficulty of predicting the future course of events The budget is the chart that the operating management is normally expected to follow

INTERPRETATION OF BUSINESS BUDGETS

The Eastern Toy Manufacturing Co, Inc, has been engaged in the manufacture and distribution of an extensive line of children's toys, games, and novelties for a period of twenty two years The management has confined its sales to fairly well known department stores, chain stores, and a few of the more important wholesale distributors of toys The business has been profitable for many years and, by constant up-to the-minute innovations, has maintained leadership in its field and steadily increased its sales volume Sales are made on unusual terms of 3 per cent discount in ten days E O M, net thirty days As a result of the substantial discount offered, the greater portion of sales are retired on the discount basis

Manufacturing operations are carried on steadily throughout the year, with a seasonal drop in the latter part of November and in December, when finished merchandise is flowing out to its customers, and in January,

when receivables are being collected from the large December sales. On December 31 receivables are at the high point for the year but by January 31 are largely collected and the funds utilized to reduce or entirely pay off bank loans. Because of this seasonal operation, January 31 has been used for many years as the fiscal date for closing the books.

Objective in Sales and Profits

On January 31, year A, the end of the fiscal year, the corporation had an authorized and outstanding capital stock, all common, of $160,000 and an earned surplus of $61,351.02. Sales of $810,210 had been handled during the year at a net profit of $42,920. Financial affairs were in a healthy shape. The receivables had been largely collected, the inventory was down, and the liabilities were moderate. After a careful study of the operations for that year, of the general condition of business, of the new products being developed, and of the improved organization, a sales budget for the next fiscal year ending January 31, year AA, was set with a 5 per cent increase at $848,060. Net profits were estimated at $54,374, an increase of $11,454. Both objectives seemed quite reasonable.

Preparation of Budget Figures

After these objectives were carefully determined, the various budgets were drawn up and submitted to the president for approval. After some minor revisions the budgets were turned over to the comptroller for translation into successive monthly income statements and balance sheets.

The comptroller forthwith presented the president with twelve individual and cumulative monthly statements of income and twelve balance sheets. Due consideration was given to seasonal variation, characterized by moderate sales and manufacturing for inventory during the first two quarters, increasing sales during the last quarter. Liabilities went up as the inventory expanded, reaching a peak in December when the inventory was largely turned into receivables, and then dropping abruptly as the receivables were collected in January and the funds immediately used to reduce the current indebtedness. Here was the series of progressive pictures to which operations must largely conform during the year if the sales and profits estimates were to be realized.

As one month succeeded another during the fiscal year, the president would receive exact income statements and balance sheets for compari-

son with the estimated financial statements If in the course of the year the net sales or profits were not coming up to expectations, then operating policies had to be examined to ascertain whether more intensive selling effort, reduced expenses, or other operating policies should be changed to produce the planned results

In this chapter the actual and estimated statements will be examined at three-month intervals The process would be identical if each of the monthly statements were analyzed

The first set of quarterly figures to be examined are those dated April 30, year A At this point we shall compare the budgeted balance sheet with the actual detailed balance sheet, the budgeted monthly income statement with the actual income statement, and the budgeted cumulative income figures covering operations for the first three months of the year with the actual income figures for the same quarter The comparisons at the end of the second, third, and fourth quarters will be based on condensed balance sheets and income statements, which usually suffice to reveal the trend of a concern's liquidity, solvency, and profitability for control purposes

First Quarter

Substantial deposit accounts of the Eastern Toy Manufacturing Co., Inc, have been maintained with two banking institutions for many years The loaning officer of one institution has kept in closer touch with the operations of the business than the officer who has handled the account at the other institution The former in the course of his banking experience has seen several concerns in highly seasonal lines of business become financially embarrassed within a few months in cases where the operating managements had failed to realize the growing strength of competitors He knew that any loans to this enterprise were good only so long as the concern maintained its leadership in a swift-moving specialty business Accordingly, as an experienced banker, he was accustomed to request and to analyze the budgeted and actual figures at periodic intervals during the year and to be posted on all developments, particularly when the concern was going through its operating peak

Figures 56, 57, and 58 on pages 259, 260, and 261 are respectively (1) a comparison of the budgeted and actual balance sheets as of April 30, (2) a comparison of the budgeted and actual income statements for the month ending April 30, and (3) a comparison of the budgeted and actual cumulative income statements for the three months ending April

30. In each case a third column shows absolute differences between estimates and actual results.

There are six noticeable contrasts between the budgeted and the actual balance sheet as of April 30. In the assets three figures appear to be out of line in the actual balance sheet: the receivables, the inventory, and the

Figure 56 Comparison of Actual and Budgeted Balance Sheets for Eastern Toy Manufacturing Co., Inc., (*as of April 30, year A*)

	Budget	Actual	Over or Under
Cash	$ 28,276.41	$ 31,148.55	$ 2,872.14
Accounts Receivable	43,138.45	33,054.29	10,084.16(U)
Inventory	199,692.50	228,705.28	29,012.78
Total Current Assets	$271,107.36	$292,908.12	$21,800.76
Fixed Assets, Net	220,589.74	227,511.80	6,922.06
Life Insurance, Cash Value	16,336.16	16,336.16	......
Deferred Charges	1,986.65	2,259.11	272.46
Other Assets	3,483.50	3,628.43	144.93
Total Assets	$513,503.41	$542,643.62	$29,140.21
Due Banks	$130,000.00	$130,000.00	......
Accounts Payable — Merchandise	27,710.95	65,074.24	$37,363.29
Accounts Payable — Equipment	5,971.98	6,171.96	199.98
Accruals: Salaries and Wages	4,157.80	3,693.91	463.89(U)
State and County Taxes	533.44	533.44	......
Social Security	975.77	3,310.83	2,335.06
Federal and State Income Taxes	8,073.25	8,073.25	......
Bond Interest	2,500.00	2,500.00	......
Interest on Loans	1,545.25	......	1,545.25(U)
Miscellaneous	2,604.58	1,001.00	1,603.58(U)
Reserves for Royalties	1,807.00	1,246.66	560.34(U)
Reserves for Advertising	3,319.00	3,017.25	301.75(U)
Total Current Liabilities	$189,199.02	$224,622.54	$35,423.52
Bonds Outstanding	100,000.00	100,000.00	......
Capital Stock	160,000.00	160,000.00	......
Surplus — February 1, Year A	61,351.02	61,351.02	......
Current Operations	2,953.37	3,329.94(L)	6,283.31(U)
Total Liabilities	$513,503.41	$542,643.62	$29,140.21
Net Working Capital	$ 81,908.34	$ 68,285.58	$13,622.76(U)
Current Ratio	1.43	1.31	......
Tangible Net Worth	$324,304.39	$318,021.08	$ 6,283.31(U)

fixed assets. In the liabilities, the accounts payable for merchandise show an alarming increase. At the same time there is an apparent shrinkage in net working capital. The most serious change, however, is the loss in current operations.

Actual receivables amount to $10,084.16 less than anticipated; the inventory is $29,012.78 greater than estimated; and the plant assets are $6,922.06 over the budgeted figure. All three changes point to less

liquidity, as further evidenced by the $13,622 76 reduction in net working capital

In the liabilities, the accounts payable for merchandise are $37,363 29 greater than the forecast, while the current operation deficit represents a difference of $6,283 31 from the expected profit This loss and the pur-

Figure 57 Comparison of Actual and Budgeted Income Statements for Eastern Toy Manufacturing Co, Inc. (*month ended April 30, year A*)

	Budget	Actual	Over or Under
Sales—Net	$35 500 00	$28 196 11	$ 7 303 89(U)
Less Freight and Reshipping		35 92	35 92
Net Sales	$35 500 00	$28 160 19	$ 7 339 81(U)
Add Increase in Inventories	17 864 84	30 443 26	12 578 42
Goods Made	$ 3 364 84	$58 603 45	$ 5 238 61
Cost of Goods Made			
Materials Used	$25 675 00	$30 440 91	$ 4 765 91
Finished Goods Purchased		2 195 04	2 195 04
Labor — Direct and Indirect	12 806 00	14 876 95	2 070 95
Labor — General Plant	1 0[illegible] 00	790 15	209 85(U)
Superintendence and Mill Office	639 50	564 50	75 00(U)
Taxes	825 00	839 24	14 24(U)
Royalty Provided For	690 00	335 08	354 9 (U)
Depreciation	1 400 00	1 400 00	
Other Manufacturing Expenses	1 945 00	1 583 92	361 08(U)
	$44 980 50	$53 025 79	$ 8 045 29
Gross Profit	8 384 34	5 577 66	2 806 68(U)
Administrative and Selling Expenses			
Commissions	$ 1 420 00	$ 1 066 20	$ 353 80(U)
Advertising	1 120 00	1 077 06	42 94(U)
Administrative Expenses	3 296 59	3 485 00	188 41
Sample Expense		1 340 18	1 340 18
	$ 5 836 59	$ 6 968 44	$ 1 131 85
Operating Profit	2 547 75	1 390 78(L)	3 938 53(U)
Financial Expenses			
Bond Interest	$ 500 00	$ 500 00	
Interest on Borrowed Money	867 00	260 25	$ 606 75(U)
Life Insurance Premiums—Net	393 8 (C)	393 85(C)	
Allowance for Early Details		70 67	70 67
Discounts Allowed and Earned Net	355 00	16 24	338 76(U)
Miscellaneous		246 9 (C)	246 9 (C)
	$ 1 328 15	$ 206 36	$ 1 121 79(U)
Net Profit or Loss	$ 1 219 60	$ 1 597 14(L)	$ 2 816 74(U)

chase of three modern stamping presses to replace worn-out equipment largely account for the shrinkage in net working capital. Add to these unfavorable changes the decline in tangible net worth of $6,283 31, and both the management and the banker have ample warning of an unfavorable trend

At the beginning of the calendar year the corporation was entirely out

of debt with its two banks. In the meantime, as the actual April 30 balance sheet shows, liabilities of $130,000 had been incurred at these two institutions to carry an increased amount of raw material, in process, and finished merchandise. This was exactly as scheduled. The expansion in the accounts payable for merchandise of $37,363.29 in excess of the

Figure 58 Comparison of Actual and Budget Income Statements for Eastern Toy Manufacturing Co., Inc. (*three months ended April 30, year A*)

	Budget	Actual	Over or Under
Sales — Net	$110,667 00	$112,230 56	$ 1,563 56
Less Freight and Reshipping		408 30	408 30
Net Sales	$110,667 00	$111,822 26	$ 1,155 26
Add Increase in Inventories	64 289 50	73,068 20	8 778 70
Goods Made	*$174,956 50*	*$184 890 46*	*$ 9,933 96*
Cost of Goods Made			
Materials Used	$ 93 387 00	$ 92,431 35	$ 955 65(U)
Finished Goods Purchased		5,821 13	5,821 13
Labor—Direct and Indirect	37,696 00	44,411,77	6 715 77
Labor—General Plant	3,000 00	2,583 63	416 37(U)
Superintendence and Mill Office	1,918 50	1,946 00	27 50
Taxes	2,475 00	2,064 25	410 75(U)
Royalty Provided For	1 807 00	1,246 66	560 34(U)
Depreciation	4 200 00	4,200 00	
Other Manufacturing Expenses	5 540 00	9,712 14	4 172 14
	$150,023 50	$164,416 93	$14,393 43
Gross Profit	24,933 00	20,473 53	4,459 47(U)
Administrative and Selling Expenses			
Commissions	$ 4,426 68	$ 4 214 12	$ 212 56(U)
Advertising	3 319 00	3,388 67	69 67
Administrative Expenses	9,590 00	11 524 14	1,934 14
Sample Expense		1,390 66	1,390 66
	$ 17,335 68	$ 20,517 59	$ 3,181 91
Operating Profit	7,597 32	44 06(L)	7,641 38(U)
Financial Expenses			
Bond Interest	$ 1 500 00	$ 1 500 00	
Interest on Borrowed Money	2,539 00	778 21	$ 1,760 79(U)
Life Insurance Premiums—Net	502 05(C)	502 05(C)	
Allowance for Early Details		98 09	98 09
Discounts Allowed and Earned—Net	1,107 00	1,994 76	887 76
Miscellaneous		583 13(C)	583 13(C)
	$ 4 643 95	$ 3,285 88	$ 1,358 07(U)
Net Profit or Loss	$ 2,953 37	$ 3,329 94(L)	$ 6,283 31(U)

budgeted figure, however, was more than twice the estimate. What had brought this about? To explain the developing balance sheet ailments, the banker turned to the operating figures.

Income Statements.—First of all the banker studied the income statement for the month of April and then the cumulative statement for the three months ending April 30. The figures for the single month disclosed

the fact that net sales had amounted to only \$28,160.19, which was \$7,339.81 under the anticipated volume, and that the increase in inventories for the one month amounted to \$30,443.26, which was \$12,578.42 over the budgeted figure. Naturally the increased manufacturing operations required to build up the inventory unduly at this time of year caused an increase in the important items entering into the cost of goods—that is, materials, direct labor, and manufacturing expense. Finally, instead of the estimated net profit of \$1,219.60 for the month, a loss of \$1,597.14 was sustained. These figures all seemed to indicate that either the purchasing department had received advantageous quotations on certain raw materials which had been purchased, or the operating management was accumulating raw material inventory in anticipation of a continued rise in prices.

The income statement for the three months ending April 30 indicated that the unfavorable symptoms had largely developed in April. Whereas the net sales were under for April, they were a trifle over for the entire three months period, indicating that net sales had been ahead of the estimates in February and March. The increase in inventories over the budget for the quarter was \$8,778.70 and for the month of April alone was \$12,578.42. Hence, the possible overstocking in inventories clearly originated in April.

Proceeding with the study of the quarterly statement, the bankers noticed that finished goods purchased were over to the extent of \$5,821.13, as no allowance whatsoever had been made in the budget for this disbursement. Direct and indirect labor were \$6,715.77 over, and other manufacturing expenses \$4,172.14 over the quarterly estimates. These excess disbursements were a logical consequence of the purchase of more raw materials than anticipated and of employing more workers for their fabrication.

The final profit figure was off appreciably. Whereas a profit of \$2,953.37 was anticipated for the quarter, a loss of \$3,329.94 was actually sustained. The amount of the profit or loss assumed during the off season in the early months of the year was, however, less important from the point of view of the banker. Operations in the early part of the year could be in the black or in the red to the extent of a few thousand dollars, and it would give no real indication of the final outcome for the year. Moreover, the amount involved was not large. Operations would, however, need to be diligently watched and studied, especially if the results for the next few months continued in the red. Sales for the first three months

of the fiscal year had always been low, and the current year was no exception.

Inventory Policy.—A review of the entire figures for the first three months now left the banker with the impression that he required more knowledge of the current policy of the management in piling up merchandise considerably in excess of the budgeted figure, and thereby increasing manufacturing expenses and current liabilities. The April 30 actual balance sheet showed an inventory of $228,705.28 in contrast to a budgeted inventory of $199,692.50, and that expansion naturally accounted for the larger accounts payable for merchandise.

In an interview Fred Altman, president of the corporation, verified the fact that wholesale prices of copper, zinc, tin, and paperboard had been rising steadily for three months and that the management had decided to anticipate a portion of its raw material requirements, especially as there was every indication that prices would be still higher in the immediate future. While agreeing with this policy if applied moderately, the banker cautioned against overexpansion of inventories in the hope of speculative profits. Wholesale prices had been known to go down as well as to go up, he warned, and if prices dropped when the business was heavy with merchandise, the inevitable result would be a substantial yearly loss. His final advice was to stick a little closer to the budget. The banker made a mental reservation to investigate the inventory policy again in a short time, for assurance that the management had not left the straight and narrow path.

Second Quarter

The budgeted and the actual balance sheets, and the budgeted and the actual income statements for the month of April and for the quarter ending April 30, which have just been examined, are the typical schedules that a banker generally obtains in analyzing a difficult situation. Sometimes the budgeted figures for each month of the ensuing year are discussed with the banker as soon as they are prepared. At such a time the banker is in a unique and favorable situation to question the executive regarding the various items, whether the anticipated sales for the year and the various items for administrative, selling, and manufacturing expenses seem reasonable, and whether some savings cannot be achieved in the case of a concern that is showing losses and needs to get on the right side of the ledger by reducing salaries of the administrative staff, by more

careful buying of machinery, parts, and equipment, or by reducing traveling and entertainment expenses After operations for the year are well under way, all the banker may do is to keep in close touch with policies, receipts, and disbursements, to see that the trend is in the right direction, and often that *is not quite so strategic or so helpful as assisting in the* determination of essential policies and budget figures before the year is really opened

Financial schedules similar to those that we have just examined were

Figure 59 Comparison of Actual Performance with Budget Forecast for Eastern Toy Manufacturing Co, Inc (*July 31, year A*)

	July		Six Months	
	Budget	Actual	Budget	Actual
Sales Invoiced—Net	$75 500 00	$42,683 07	$283,337 00	$276,792 41
Overhead Expenses				
Indirect Labor	$ 4 820 60	$ 2 934 02	$ 17,152 38	$ 18 018 06
Manufacturing Expenses	6 731 16	7,517 42	40,387 00	44 475 81
Administrative Expenses	3 657 50	3,823 96	21,945 00	23,738 27
Total	$15,209 26	$14 275 40	$ 79,484 38	$ 86,232 14
Net Profit	$ 1,573 60	$ 3 406 68	$ 10,414 42	$ 7,469 84
Financing				
Bank Borrowings			75,000 00	75,000 00
Notes Payable for Mdse	16 500 00	16 903 83	16,500 00	16,903 83
Total Requirements	$16 500 00	$16,903 83	$ 91,500 00	$ 91,903 83
Working Capital Position				
Cash			$ 37,345 35	$ 10,240 88
Accounts Receivable			61 081 45	75,118 75
Inventories				
Materials and in Process			265,051 00	104 911 51
Stock Held Against Confirmed Orders				193 866 63
Current Assets			$363,477 80	$384 137 77
Less Current Liabilities			261 746 41	302,366 91
Net Working Capital			$101,731 39	$ 81,770 86
Current Ratio			1 39	1 27

submitted to the banker for the fourth and fifth months, along with cumulative income statements up to the ends of those months The sixth month came and went The statements for the month of July and for the six months ending July 31 appear in condensed form in Figure 59, above Here on one page are a limited number of figures that summarize the results of operations and the financial condition of the business in one brief schedule instead of three full schedules If after a study of these condensed figures, more information were needed, the banker would examine the underlying data from which the summary had been prepared

Income Account.—While the actual sales invoiced during July were materially less than the estimate, the actual sales for the first six months of the year were only 2.3 per cent less than the budgeted net sales of $283,337. Apparently the volume of business from one month to another was fluctuating somewhat away from the expected volume, but cumulative figures were fairly close to the estimated figures. After all, accuracy in cumulative results is more important than having the figures accurate for respective months. For the first quarter of the year net sales were $1,155.26 over and for the six months $6,544.59 under. There was no doubt that the sales department was functioning smoothly and effectively.

Overhead expenses, likewise, were pretty much in line, a trifle under for July, but somewhat over for the six months. For the first half of the year, budgeted overhead expenses had been estimated at $79,484.38 and had actually amounted to $86,232.14, the largest difference being found in the manufacturing end of the business.

Net profit figures were now more encouraging. The early losses had been recovered, and operations were in the black. Actual profits in July were more than double the estimate. The budgeted net profit for the six months had been $10,414.42, and the actual net profit was $7,469.84. This improvement during the second quarter would indicate that 45.7 per cent of the six months' profits had been earned in July, even though the net sales were below expectations for that one month.

The summary of financing requirements also disclosed some variations from the plans made early in the year. The budgeted figures for July provided for $16,500 of notes payable for merchandise, but slightly more was used. As a result, the outstandings in the form of bank borrowings and notes payable for merchandise were just about as planned. All in all, the operating figures now seemed to be pretty much in line.

Working Capital Position.—When the banker came to the summary of the working capital position of the corporation, he observed that gross current assets were $20,659.97 over the budget, while current liabilities were $40,620.50 over the estimate. The operating loss incurred during the first quarter had been made up by operating profits in the second quarter, but even so, the net working capital showed a larger difference between the budgeted and the actual figures than as of April 30, the shrinkage at the end of the first quarter amounting to $13,622.76 and at the end of the second quarter to $19,960.53. That was a substantial variation. What was the reason?

Even if the full budgeted net working capital had been retained, it

would not have been any too much going into the peak of the season with current liabilities of $302,366 91 Affairs now had to be watched closely to be sure that nothing radical happened during that period of the year, when every department of the business needed to be functioning on all cylinders The only possible reasons for such a decrease in net working capital would be dividend disbursements about which the banker knew nothing, the retirement of some portion of the bonds, or increased expenditures above the budget allowance for machinery, fixtures or other fixed assets Irrespective of cause, the management needed to be warned that the working capital position under no circumstances should be reduced further

Of the current assets, the cash was under, the receivables higher, and the merchandise materially over The merchandise was certainly heavy, but 65 per cent of the inventory was against confirmed orders and was held against actual shipping dates running from August to December Hence, the business was not as overextended as appeared at first glance There was no doubt, however, that the inventory would have to be watched

Two weeks after presentation of these statements the president of the corporation called at the bank to discuss the possibility of borrowing an additional $25 000 The banker's first inquiry concerned the noticeable drop in net working capital No dividends had been paid, and no part of the bonds had been retired What had happened, the president explained, was that two new boilers had been needed and purchased early in May Then an addition had been made to one end of the plant so that the manufacturing operations could be routed more efficiently Perhaps these expenditures of approximately $16 000 were justified from an efficiency engineering standpoint, but financially they were unwise After full discussion of the situation the banker cautioned the president not to reduce working capital at any time during the balance of the year without first talking with him More, and not less working capital was needed to support operations during the approaching peak season

Altman then brought up the problem of inventory Prices were still going up Purchases had been kept close to the budgeted figures since the conference at the end of the first quarter Should the corporation not lay in more raw material, since no end to the rise in prices seemed in sight? Again the banker cautioned against deviation from the budget, pointing out that greater losses are probably taken from revaluing inventories downward after a drop in prices than from any other single cause

Third Quarter

The third quarter, which ended October 31, came around with its operating record. Business was now definitely upward. Sales were increasing as wholesalers were taking their orders. In November the department stores out West would begin to ask for shipments, and by early December the eastern department stores would want their merchandise. Of estimated sales of $848,060 for the entire year, only $276,792.41, or 32.6 per cent, had been shipped during the first six months. If the budgeted figures were to be equaled or exceeded, more than two thirds of the sales would have to be made in the second half of the year, as was natural in this highly seasonal industry.

Income Account.—The figures for October and for the nine months ending October 31 showed the results of the pick-up in sales. During the third quarter net sales aggregated $293,545.40, or more than the sales during the first six months of the year. More than half of this sum represented business handled in October. The sales department was running pretty close to par, being only 1.7 per cent off the estimate for the entire nine months. It was now evident that a splendid job had been done by the management in making the estimates when the budgets had originally been prepared and also by the sales organization in carrying them out.

Overhead expense items were again in line. Actual disbursements for indirect labor, administrative expenses, and manufacturing expense were 1.7 per cent under the estimated figures for the nine months. Real progress had been made in the third quarter, as at the end of the first six months overhead expenses had exceeded the estimates. The management was to be commended for this showing, as overhead is the section that often upsets the budget.

The net profit figures were now above earlier expectations. For October net profits were slightly in excess of the estimate, and for the nine months they were approximately 35 per cent in excess of the budgeted net profits of $32,378.72. Apparently the corporation was going to have a splendid year. As a result of these profits, the net working capital should show some improvement over the figures that had caused such concern at the end of the first six months of operation.

Working Capital Position.—Financing requirements in October exceeded the budget, because of heavier receivables and inventory than anticipated. The bank debt was $5,850 in excess of the budget figure, and

notes payable for merchandise were $22,898 37 over The working capital position, which had been off so appreciably on July 31, was considerably improved, however, at the end of nine months Not only was the net working capital of $118,504 28 slightly in excess of the budgeted figure of $114,983 69 but it reflected a happy and unexpected increase of $36,733.42 during the three months ending October 31 That was prog-

Figure 60 Comparison of Actual Performance with Budget Forecast for Eastern Toy Manufacturing Co, Inc (*October 31, year A*)

	October		Nine Months	
	Budget	Actual	Budget	Actual
Sales Invoiced—Net	$143 200 00	$149 402 89	$580 237 00	$570 337 81
Overhead Expenses				
Indirect Labor	$ 4 123 80	$ 2 442 31	$ 29 820 98	$ 26 893 58
Manufacturing Expenses	7 639 50	6 170 74	63 932 50	63 304 34
Administrative Expenses	4 229 14	4 709 76	34 673 34	36 074 79
Total	$ 15 992 44	$ 13 322 81	$128 426 82	$126 272 71
Net Profit	$ 11 858 85	$ 12 270 29	$ 32 378 72	$ 43 747 69
Financing				
Bank Borrowings			$100 000 00	$105 850 00
Notes Payable for Mdse				22 898 37
Total Requirements			$100 000 00	$128 748 37
Working Capital Position				
Cash			$ 61 156 87	$ 8 665 69
Accounts Receivable			100 012 45	155 854 98
Inventories				
Materials and in Process			214 519 50	100 082 44
Stock Held Against Confirmed Orders				167 919 14
Current Assets			$375 688 82	$432 522 25
Less Current Liabilities			260 705 13	314 017 97
Net Working Capital			$114 983 69	$118 504 28
Current Ratio			1 44	1 38

ress, all the result of the increased profits which had been kept in current assets

As a result of carrying materially heavier receivables and larger inventories than estimated, the currents assets were $56,833.43 over the budgeted figures Naturally the current liabilities were up almost the same amount Here was the one place where actual operations had run widely astray from the budgeted figures The increase in receivables, however, had occurred as a result of seasonal shipments, and of the inventory on hand, about two thirds had been stocked and packed for customers and was awaiting shipping instructions Real effort needed to be made now to see that the inventory moved as anticipated in November and December

Everything depended upon the sales of these two months as to whether the year would be profitable or a dismal failure.

Fourth Quarter

Christmas came and went, and the banker received favorable statements for November, December, and January. One more profitable season had been added to the record of this established enterprise. Unfortunately, however, profits had not turned out as high as appeared at the end of the first nine months, when the actual profits were 35 per cent in excess of the budgeted figure. From July to November operations might have seemed somewhat extended with a heavy inventory and excessive liabilities, but that was now water over the dam. The sales had been made, and then the receivables had been largely collected in December and in January. On January 12, bank borrowings had been liquidated in full, and liabilities for current merchandise obligations and for accruals had been reduced to $96,310.76. That was heavier than the anticipated liabilities of $64,269.87 because of a greater carryover of merchandise than had been budgeted, but all in all the results were commendable.

A recapitulation (see Figure 61) for the year showed a splendid job in constructing and carrying out the budget, though the banker had found it necessary to repeat warnings regarding working capital position and the accumulation of inventories. The warning about heavy purchases had borne fruit, as early in November wholesale prices had begun to ease off, and the tendency had continued through December and into January. If heavy purchases of raw materials had been made, profits would probably have been entirely eliminated by inventory losses. There is probably no one policy so essential for the successful operation of a business enterprise as adhering to the purchase budget.

Income Account.—Net sales for the fiscal year had reached $842,-576.78, only slightly below the budgeted figure of $848,060. Net profits were $47,684.26, somewhat lower than the budgeted profits of $54,374.91. Net profits for the nine months had been approximately 35 per cent ahead of schedule, but price cuts to move several lines that would be obsolete in the following year had been made in November and December, and these cuts had held down the profit figures for the last quarter. Expenses had been kept well in hand and were actually under the budgeted sum in the aggregate.

Working Capital Position.—The working capital position showed the remarkable change that had taken place during the last quarter of the

fiscal year The current assets and the current liabilities were both over the budgeted figures The big change is noticed when the figures are compared with those of October 31 The current assets had been reduced from $432 522 25 to $225 496 04, reflected in the liquidation of receivables and merchandise At the same time the current liabilities had been liquidated from $314,017 97 to $96,310 76 As the funds were collected, they had been used to pay off the bank and to reduce accounts payable to merchandise creditors

Figure 61 Comparison of Actual Performance with Budget Forecast for Eastern Toy Manufacturing Co Inc (*January 31, year AA*)

	January		Twelve Months	
	Budget	Actual	Budget	Actual
Sales Invoiced—Net	$35 063 00	$33 358 30	$848 060 00	$842 576 78
Overhead Expenses				
Indirect Labor	$ 2 726 68	$ 3 011 88	$ 44 411 40	$ 35 266 69
Manufacturing Expenses	4 472 50	7 007 41	80 621 00	82 404 71
Administrative Expenses	2 386 94	3 040 79	44 129 00	47 016 23
Total	$ 9 586 12	$13 060 08	$169 161 40	$164 687 63
Net Profit	$ 2 640 73	$ 1 832 87	$ 54 374 91	$ 47 684 26
Financing				
Bank Borrowings				
Notes Payable for Mdse				
Total Requirements				
Working Capital Position				
Cash			$ 66 445 30	$ 62 440 09
Accounts Receivable			55 158 45	57 902 31
Inventories				
Materials and in Process			71 971 00	104 153 64
Stock Held Against Confirmed Orders				
Current Assets			$193 574 75	$224 496 04
Less Current Liabilities			64 269 87	96 310 76
Net Working Capital			$129 304 88	$128 185 28
Current Ratio			3 01	2 34

Recapitulation

Bankers may require budget estimates and actual results for comparison at frequent intervals in those cases where credit is extended on an unsecured basis and the business judgment of the creditor is questionable, where a loan is frozen, or where a concern is overtrading or is in an over extended position

In such situations it is only good credit procedure for the banker to know all of the plans of the operating management, to analyze them and to help the business get back on a sound earnings basis with a healthy distribution of assets and liabilities

chapter XII

THE TRIAL BALANCE

ONE DAY A RUMOR WAS STARTED IN THE NEW YORK TEXTILE PIECE goods market that a particularly well-known, established, and successful dress manufacturer was in an extended financial condition. Such a rumor in itself was not surprising, but when bankers heard the name of the concern that was said to be somewhat embarrassed, they were quite incredulous. It was one that had been operated profitably and aggressively for many years, had met its obligations promptly through prosperous times and recessions, and, despite the rather intense competition which always existed in the manufacture of popular-priced dresses, had maintained a satisfactory financial condition.

As is customary in such cases, a few of the larger creditors invited the principal partner in the business to visit them one sunny afternoon and to bring along a copy of his latest trial balance. A casual glance at the figures contained in the trial balance indicated no particular cause for alarm. The debt was heavy, and the cash and receivables were fairly low, but the condition was typical of a manufacturer of dresses that traded heavily and was going through the peak of its production season. The general tendency was to discount the rumor as nothing but idle gossip.

One experienced banker, however, did not dismiss the trial balance after the first casual glance. He proceeded to scrutinize it carefully. One small item, "Loans and Exchanges," amounting to $1,504.63, caught his attention. He asked the manufacturer to furnish a detailed schedule of the loans and exchanges. When, despite his promise and several persistent reminders, the manufacturer failed to do so, the banker began to wonder if he had not found Achilles' tendon. When his bank's loan of $20,000 fell due three weeks later, this banker, under the circumstances, refused to renew and obtained repayment.

About sixty days later the concern was unable to meet its maturing obligations, and a creditors' meeting was immediately called An examination of the books of account then disclosed the fact that the manufacturer had been indulging in more than a reasonable amount of high finance Several of his close associates and competitors in the manufacture of popular priced dresses had invested funds in the stock market and had made reasonable profits in a rising security market Not so with our friend He was not content with a mere 30 or 50 per cent increase in the value of investments made with his own surplus cash and such cash as he could borrow from friends and relatives He aimed for a 100 or 125 per cent profit by playing the commodities market. The 'Loans and Exchange account in his general ledger had received enough entries to be the despair of his overworked bookkeeper Liabilities to loyal friends and relatives who had loaned funds to him had been conveniently, if unsoundly, offset by the amount owed him by his commodity broker This amount had miraculously increased to within a few thousand dollars of the obligations due those who had loaned funds to him

DESCRIPTION OF TRIAL BALANCE

Since the two statements most important to the credit man, the balance sheet and the income statement are derived from a trial balance, he should logically find the trial balance itself extremely useful Furthermore, in between balance sheet dates, the trial balance is valuable as an interim financial statement

The basic theory of double entry bookkeeping is that debit and credit entries must be equal in *amount* In order to prove that the books are in balance, most concerns on the last day of each month add together all the debit items and then all the credit items

A columnar tabulation of all such items is a *trial* balance Theoretically this may be a complete columnar listing of all of the items, but in actual practice it is simply a listing of the net balance in each account For instance, instead of showing the gross amount due to each creditor and the gross amount paid to each creditor, the bookkeeper balances the amounts paid against the amounts due to each creditor Then he totals all of the net amounts due to each creditor, and he has an amount representing the accounts payable

Because a trial balance is a listing of all credit and debit balances, it contains both balance sheet figures (assets and liabilities) and operating figures (income and expense items) From the physical inventory as of

the date of the trial balance, and from the trial balance itself, the accountant then prepares the balance sheet and income account.

As the preparation of a balance sheet usually requires a closing of the books and the taking of a physical inventory,[1] balance sheets are usually drawn up only once or twice each year. If a debtor requests credit during his busy season in excess of that earlier agreed upon, it is often unreasonable to ask him for a complete balance sheet at that time, unless the additional credit sought is exceptionally large. The banker, however, need feel no compunction about asking the debtor for a copy of his latest trial balance, and there is seldom any valid reason why a debtor, especially one whose business is not widely scattered, should not be able to supply one within a very few days.

In requesting a trial balance, the banker should also ask the debtor for an estimate of his inventory on the date of the trial balance. If the lender is at the borrower's place of business and if the stock is centrally located, visible, and not difficult to evaluate, he may well ask for permission to look it over, and thus form his own independent opinion of its approximate value. The need for an estimate of the approximate current value of the stock of merchandise will be explained shortly.

INTERPRETATION OF TRIAL BALANCE

To the experienced banker the trial balance effectively discloses the following financial information subsequent to the issuance of a balance sheet:

1. A closing of the books on an irregular date, or the possible inaccuracy of the last balance sheet.
2. The amount of inventory required to maintain the amount of capital shown on the last balance sheet.
3. The approximate inventory on the date of the trial balance.
4. The approximate overhead expenses of the business.
5. Unusual transactions not apparent from a condensed balance sheet or income statement.

Closing of Books on Irregular Date or Inaccuracy of Last Balance Sheet

One of the first steps in trial balance analysis is to compare the inventory and the surplus, or the partnership or proprietorship capital account, as

[1] Under the "retail method" of valuation, a perpetual inventory is kept. A physical inventory is unnecessary to prepare a balance sheet; the book inventory obtained from the merchandise record or stock ledger may be used at any time.

the case may be, contained in the trial balance with the corresponding figures shown on the last previous balance sheet. Since these items do not change one cent on the books of a concern between the dates of balance sheets, the slightest variation in either should be a signal for further careful investigation or questioning. Such a variation might mean either of the following:

1. A closing of the books on a date other than that of the last balance sheet at hand. In such a case the banker should immediately request a copy of that balance sheet and income statement and ask why they were prepared. Possibly the statements were taken off at the insistence of some other bank or trade creditor. In that event the banker should promptly check with this creditor and obtain his up-to the-minute experience and opinion of the account.

2. An inaccuracy in the last balance sheet. A case in point is that of a small woolen jobber who was the sole owner of his business. This man submitted balance sheets annually to his creditors, but declined to give out income statements. His capital showed small but steady increases, which created the impression that he was operating profitably. A trial balance that he gave one bank creditor, however, disclosed the following: "John Herrin—Capital $28,394.26—whereas the previous balance sheet had shown "John Herrin—Capital $37,984.14." A study of the trial balance showed the banker another item: "John Herrin—Loans $9,589.88." In other words, John Herrin had been lending money to the business over a period of several years, but, wishing to create the impression he was operating profitably, he had never disclosed that simple fact. Technically he was justified in lumping his loan and capital accounts together since the business was a proprietorship and all of his loans were at the risk of the business. Nevertheless, the banker's opinion was necessarily affected by the attempt of the merchant to mislead his creditors into believing that he had been operating profitably.

On page 275, Figure 62, is a balance sheet of a manufacturer of men's and boys' dress and sport shirts as of December 31, and Figure 63 on page 276 is a simple trial balance dated February 28, taken off two months after the date of the balance sheet. A glance at these two financial statements shows that the inventory on the two dates checks to the cent, being carried at $32,713.64 in both schedules, and that the sum of J. Feldman's capital of $23,092.74 and of R. Moskowitz's capital of $19,178.80 on February 28 was the exact amount of the tangible net worth on the previous December 31, of $42,271.54. This was as it should be.

Inventory Required to Maintain Capital

The amount of inventory needed to maintain the same capital shown in the previous balance sheet is computed by considering only the assets and liabilities. In making these computations, the analyst may find it helpful to label these figures "A," "L," and "O" for asset, liability, and overhead items, respectively, as has been done in the trial balance on page 276.

Figure 62 Balance Sheet for Manufacturer of Men's and Boys' Shirts (*December 31, 19—*)

Assets			Liabilities	
Cash on Hand	$ 50.29		Accounts Payable	$35,194.58
Cash in Banks	3,712.08			
		$ 3,762.37	Due to Employees	1,410.87
Accounts—Not Due	$32,592.08		Accruals	1,913.21
Less than 30 days past due	4,581.48			
30 to 60 days past due	1,333.82			
Total Receivables	$38,507.38			
Less bad debt reserves	2,243.68			
Less discount reserves	577.60			
Total Reserves	$ 2,821.28	35,686.10		
Raw Material	2,840.69			
In Process	7,514.55			
Finished	22,358.40			
Inventory		32,713.64		
Machinery and Fixtures	8,279.92			
Less Depreciation	2,024.89	6,255.03		
Loans Receivable		625.00		
Deposit on rent		400.00		
Due from officers and employees, salesmen		91.29		
Prepaid expenses, prepaid insurance		665.10		
Advanced to contractors		591.67	Net Worth	42,271.54
Total		$80,790.20	Total	$80,790.20

The analyst may encounter difficulty, however, in distinguishing real accounts (assets and liabilities) from nominal accounts (income and expenses), as the wording of items in the trial balance is at times quite ambiguous. The items not readily discernible, however, are usually so small in amount as not appreciably to affect the analysis.

For example, the item "Salesmen's Control," amounting to $168.56, cannot be easily classified, but it is so small that its inclusion or exclusion from the liability or expense totals will not affect the analysis materially. Likewise, the item "Insurance" of $742.05 is an asset if prepaid, but an expense if a premium for the current period.

After he has examined and labeled the items, the analyst totals the liabilities and capital accounts He next totals the asset items, excluding the previous inventory Then he subtracts the total of the assets, exclu-

Figure 63 Trial Balance for Manufacturer of Men's and Boys Shirts (*February 28, 19—*)

Cash in Bank	(A)	$ 1 755 00		
Cash on Hand	(A)	14 62		
Accounts Receivable	(A)	41 749 52		
Reserve for Bad and Doubtful Accounts			(L)	$ 2 243 68
Merchandise Inventory—January 1 19—		32 713 64		
Loans and Exchanges	(A)	472 75		
Machinery and Fixtures		7 611 00		
Reserve for Depreciation—Machinery and Fixtures			(L)	2 024 89
Deposits	(A)	400 00		
Accounts Payable			(L)	21 504 85
Notes Payable—Bank			(L)	9 000 00
Salesmen s Control			(?)	168 56
J Feldman—Capital			(L)	23 092 74
J Feldman—Drawings		680 62		
R Moskowitz			(L)	19 178 80
R Moskowitz				516 96
Sales				36 866 52
Sales Returns and Allowances		1 457 55		
Discount on Sales				120 38
Collection of Accounts Previously Written off				15 10
Insurance Charged to Contractors				20 26
Purchases—Raw Materials		13 742 13		
—Supplies		2 380 24		
Freight In		125 43		
Discount on Purchases				341 10
Labor—Inside		1 525 45		
Labor—Outside		5 412 98		
J Feldman—Salary	(O)	315 00		
R Moskowitz—Salary	(O)	350 00		
Commissions		60 96		
S Brown—Salary	(O)	537 17		
Miscellaneous Selling Expense		649 83		
Office Salaries	(O)	189 00		
Rent	(O)	275 00		
Insurance	(A)	742 05		
Freight and Expressage Out		164 51		
Legal and Auditing	(O)	125 00		
Telephone and Telegraph	(O)	142 00		
Stationery and Printing				1 58
Light and Power	(O)	27 09		
Factory Expense		24 77		
Miscellaneous General Expenses	(O)	1 187 30		
Postage and Carfare	(O)	128 65		
Taxes—New York Unemployment Insurance	(O)	7 48		
Social Security	(O)	3 68		
Interest Paid	(O)	125 00		
Totals		$115 095 42		$115 095 42

sive of the inventory, from the total of the liabilities The difference between these two totals will be the amount of inventory required to maintain the capital as of the last balance sheet If the total of the assets,

exclusive of the inventory, exceeds the total of the liabilities including capital, the concern would need a negative inventory to break even on operations. This is possible, but not probable, for it would indicate that the concern had made an exceptionally large profit since the last statement date.

The shirts of the manufacturer whose trial balance is shown in Figure 63 are cut on the premises, but are sewn by outside contractors, a technical method of operation common in the garment trades. The sum of the asset (A) items is $52,744.94, and that of the liability (L) items is $77,-044.96. The difference of $24,300.02 is the amount of inventory needed to maintain the capital shown on December 31.

Estimate of Inventory at Date of Trial Balance

Our next step is to make an estimate of the inventory on February 28, the date of the trial balance and to see if our manufacturer has operated profitably or unprofitably since December 31. An understanding of the significance of gross profit, also known as "mark-up," is essential in this method of estimating inventory.

Assume that a retailer of furniture has on hand a davenport that cost him $100. Today he lays in stock another similar davenport, also costing $100. Tomorrow he sells one davenport for $180. What he has left is one davenport worth $100—not one worth $20 as might incorrectly be assumed by subtracting the sale of $180 from the cost of the two davenports, $200. In his sale of $180 he has made a gross profit of $80, or 44 4/9 per cent. This mark-up must be deducted *to reduce the sales item to cost.* The closing inventory at cost is the sum of the opening inventory and purchases at cost less the $100, *cost of goods sold.* This leaves inventory on hand of $100.

This in itself is simple enough provided we know the percentage of gross profit for the business being analyzed. Our trial balance does not give that information. There are three possible sources from which to estimate such a figure:

1. Previous income statements of the concern in question will give a fairly accurate idea of its gross profit.

2. If no recent income statement of the concern is available, one may turn to the trade association active in that industry for an approximate gross profit figure of an enterprise transacting about the same volume and type of business.

3. In the absence of either of these two sources of information, a recognized accountant, an outstanding operator, or any competent authority in that division of industry may furnish an estimated percentage.

Care must be taken to distinguish between mark-up and gross profit. The merchant who purchased a davenport for \$100 and sold it for \$180 *marked it up* \$80 on \$100, the cost, or 80 per cent. His gross profit, however, was \$80 on a \$180 sale, or 44⅘ per cent. Mark-up and gross profits percentages are readily convertible by shifting the base. For instance, a mark-up of 25 per cent on cost is equivalent to a gross profit of 20 per cent on sales, and a mark-up of 100 per cent to a gross profit of 50 per cent. Mark-up is figured on the cost of goods sold, and gross profits on net sales.

To calculate the shirt manufacturer's inventory, we must first determine his approximate gross profit. Let us assume that, either from previous income accounts or from some trade authority, we have arrived at a reliable figure of 20 per cent as the gross profit. Then the inventory as of February 28 is estimated as follows:

Inventory on December 31		\$32,713.64
Plus Purchases—Raw Materials		13,742.13
Supplies		2,380.24
Freight In		125.43
Plus: Labor—Inside		1,525.45
Outside		5,412.98
Total		\$55,899.87
Less.		
Gross Sales	\$36,866.52	
Deduct—Returns and Allowances	1,457.55	
Net Sales	\$35,408.97	
Less		
Gross Profit (20 per cent of \$35,408.97)	7,081.79	
Estimated Cost of Sales		\$28,327.18
Estimated Inventory on February 28		\$27,572.69

The difference between this estimated inventory and that necessary to break even is the indicated profit, as follows:

Estimated Inventory	\$27,572.69
Break-even Inventory (p. 277)	24,300.02
Indicated Net Profit	\$ 3,272.67

Approximate Overhead Expenses

The margin of profit and the percentage of gross profit usually vary with the volume of net sales. As the volume expands, the margin percentage figure usually goes up, since part of the expense of transacting

business is more or less fixed.[2] For the same reason the margin invariably declines with contracting sales. This makes it important for the banker to watch the overhead or fixed expenses of the business.

Opinions vary as to which items constitute overhead. For the purpose of a credit analysis, those charges that go on irrespective of the volume of business may be considered as overhead. Expenses such as rent, insurance, office and administrative salaries, heat and light, and accounting expense will not vary enough with the volume of business to affect the analysis.

The approximate overhead may be calculated by dividing the sum of the overhead items contained in the trial balance by the volume of net sales for the period. Whether the resultant percentage is in line may be determined by a comparison with previous figures of the same concern or by reference to any of the sources mentioned on pages 277–278. Overhead is particularly important in the case of a concern transacting a large volume of business on its investment, or of one that is subject to sharp seasonal influences, such as a manufacturer of bathrobes or a wholesaler of lumber. Sometimes when a season opens late, a highly seasonal business is almost wiped out before it gets into full swing.

In the trial balance in Figure 63, certain items that appear to be more or less constant irrespective of the volume of sales have been labeled "O" for overhead. Here again exception may be taken to the inclusion or exclusion of particular items, but the controversial ones are too small to affect the analysis. The sum of the overhead items in the left-hand column is $3,412.37. This total divided by net sales for the two months gives an overhead of 9.61 per cent, which is not excessive. For the year, however, the percentage of overhead will probably be higher, as the charges will remain almost constant, whereas the level of net sales will probably drop as a result of seasonally slack months.

Unusual Transactions

A balance sheet may be likened to a picture of a business at a given moment. A snapshot of an automobile might not indicate whether the car is going backward, forward, uphill, downhill, or standing still. So it is with a single balance sheet not supplemented by previous balance sheets or by an income statement. Since the owner of a business knows months ahead that a picture of his business is going to be taken at a given

[2] See Roy A. Foulke, *Practical Financial Statement Analysis* (5th ed.; New York: McGraw-Hill Book Co., Inc., 1961), chap. 20, pp. 538–57.

date, he naturally attempts to have that business make the best appearance when the time for the photographer arrives

Unlike the balance sheet, the trial balance is hard to window dress and gives operating figures that may help in determining the direction of the business Many items that are lumped with others or cleaned up by the fiscal date, are shown by themselves in the trial balance Below are outlined five such items which may be straws in the wind to a banker considering a doubtful risk

1 "Loans and Exchanges" may indicate some type of high finance as described at the beginning of this chapter

2 "Overdrawings" by the principals or some salesmen may indicate extravagant living habits

3 "Heavy Merchandise Returns" may mean something is going wrong in the production or designing departments

4 "Protest Fees" or "Bank Service Charges" may indicate inadequate balances and a possible lack of bank accommodation in the future

5 "Interest" on purchases may mean that the concern is giving notes for merchandise or running slow in paying its current bills

An abnormal increase in any of these items, as revealed by the trial balance, would be sufficient reason for a more careful investigation and analysis For instance, one banker stopped at the item "Interest," which seemed to him exceptionally large After determining the bank debt on the previous fiscal date, the bank debt on the trial balance, and the volume of business being transacted, he calculated what seemed to him would be the maximum and the average bank debt for the year Even at the maximum debt, the interest payments appeared heavy, and he was forced to the inevitable conclusion that his customer was hypothecating his accounts receivable and was paying a heavy charge in the process This, as shortly revealed, was actually the case

The analysis of credit information is first, last, and always a logical procedure—a process of reasoning based upon experience and knowledge There is a logical explanation or interpretation for every piece of what seems to be extraneous information When the proper interpretation is made, there exists a basis for determining the credit position of every enterprise under investigation

part four

MAKING THE LOAN

chapter XIIII

IMPORTANT CONSIDERATIONS IN MAKING BANK LOANS

ALL CREDIT INFORMATION, WITHOUT EXCEPTION, FALLS INTO THREE categories: antecedent information, investigational facts, and financial information. There is some overlapping of information in these three categories. In Chapter XXIII we shall see how the successful operation of a business enterprise is dependent upon the skill, experience, knowledge, vision, aggressiveness, and ability of the active management to make and to carry out logical plans of operations. In this broader sense, all credit information, not only the record and the experience of the executive staff and the antecedents of the business enterprise itself, but also the manner in which trade obligations are paid, the basis on which bank loans are contracted, and the inherent financial strength or weakness of a business enterprise, become by-products of management qualifications. In the final analysis management makes or breaks the business enterprise.

The banker must conduct a thorough investigation of the experience and the record of those who comprise the active management of a business enterprise, by carefully tracing all previous occupations of each important member of the executive staff as an employee or as a principal and ascertaining the degree of thoroughness, conscientiousness, and success with which each of these earlier positions was filled. This investigation should be supplemented by direct personal contacts over a period of years. Both sources of knowledge are essential.

THE SIGNIFICANCE OF MANAGEMENT

"Management" is a dynamic word. There is something magical about the term to commercial bankers who have watched the rise and fall of

hundreds of business enterprises and have seen how quickly confusion may be changed to ordered success.

In business, management is perspective, order, power, and timing. It is in a sense the chemically scientific compounding of human beings, raw materials, and capital out of which flows a stream of economic goods and services. Management is the priceless faculty in some men that enables them to drive waste from industry, increase production, expand distribution, and at the same time reduce costs. It replaces losses with profits and inefficiency with efficiency. Management is, in other words, the simple reason for the difference between economic success and failure in the business world.

To illustrate the fundamental significance of management, let us consider a business enterprise that has had experienced, capable management and lost it. Such an enterprise was founded in 1936 by two men, one of whom was thoroughly familiar with the problems of financing a business, while the other was a genius in sales control, promotion, and management. From its very inception the business grew by leaps and bounds and, in a brief space of six years, became one of the leading concerns in its field. Year after year dividends of 20 per cent were paid upon the common stock. One day that founder who had been in active charge of the sales end of the business died. Then the financial man decided to retire. Arrangements were made whereby three principal assistants would buy the business and take full charge of its activity. The good will of the name alone was worth $500 000.

For one year the new management made a profit. Then came a recession in business with which the new executives were unable to cope. For two years operations were conducted at a loss. The banks that were involved stood by. The losses continued for two years more, during which the bank lines were maintained. Finally, an outsider was brought in, at the insistence of one of the larger stockholders, to analyze the situation. An examination disclosed the fact that sales had declined in seven years from $4,000 000 to $600 000 per year, and 82 per cent of the accounts had been lost. So long as the business had friendly, but aggressive, sales management and effective financial control, the principal assistants were sufficient unto themselves. When sales and financial management was cut off, the business began to wilt and was finally liquidated.

Management is a topic of the utmost mutual interest to the banker and to the businessman, whether the latter be engaged in engineering, accounting, production, or selling. The banker's interest in management is

threefold. He seeks the most advanced, efficient, but conservative management practice for his own banking business. Through wide-awake management for every one of his borrowers, he seeks safety for his own credit lines and financial growth for those he serves. Finally, because the roots of his business are so deeply and so broadly embedded in our economic life, he looks with eager concern on every development of management knowledge and practice that may improve the position of any or all business enterprises.

When a business enterprise has capable management in the production and the marketing divisions of its activity and a healthy spirit in its organization, the management of its finances often becomes less difficult, and the banker's problem less complicated. The executive head of such a business has a definite budgeted program for each month of the year. His profit objective and sales plan are determined on the basis of competition, market, and business conditions. His production program and supplies, materials, labor, and cash requirements are definitely estimated with a view of enhancing net profit. As a result, the major swings of business hazard may be greatly modified. These principles are the basis of successful business operations. Yet, many business enterprises operate year in and year out on the ragged edge of mere existence without these essentials and the assurances they give.

The science of operating management has made notable advances during the last fifty years. Mass production has been developed on a larger and larger scale. Costs have been reduced for many products, processes simplified, and standardization carried into countless phases and ramifications of business.

Along with the amazing solution of these tangible problems, there have arisen greater and less tangible problems, such as unemployment, intensified competition, and the fallibility of the human factor. Capable management, however, has demonstrated its ability to transcend problems of location, handicaps of environment, and the constant changes of the times. Capable management may work with maximum results hand in hand with favorable factors, but even singlehanded it is the dominating influence in deciding the success or failure of any business enterprise, whether a small retail candy store or a producer and distributor of men's clothing on a national scale.

What, then, are the fundamental differences between successful and unsuccessful operating managements from the point of view of the commercial banker? These important differences are seven in number.

Definite Program

The first difference is that successful management has a definite program, while unsuccessful management gropes, acts without facts, proceeds without a program Incompetent management enters each new year hoping that somehow profits will prove adequate and that the business will enjoy smooth sailing, but does little to achieve its objective Successful management, on the other hand, secures essential facts, sets up a definite monthly program or budget for its operations, and charts a course to which the wheel is held despite obstacles and temporary setbacks On this course a competent management unifies and harmonizes the entire working organization

With all of the emphasis that has been placed upon management, the banker still finds in many business concerns neither a well planned sales and production program nor the perspective to keep inventories down reasonably in a rising market Yet, without this basic knowledge, the banker is hardly in a position to grant loans intelligently, since he must first have exact pertinent information regarding the regular periodical requirements for materials, payroll, and supplies if he is to determine the fluctuating cash requirements of a business from month to month Only reasonably planned production based upon reasonably planned marketing will enable him to arrive at working capital requirements and evaluate a credit risk

Inventory Management

The second difference between successful and unsuccessful management involves the important question of inventory control A heavy inventory in a falling market may be disastrous The responsibility for an inventory condition in the long run rests upon the banker as well as upon the operating management of a business, for the banker often finances the excess inventory While inventory should not be curtailed unreasonably, the fact remains that, with rapid cyclical and style changes, speculation in excessive inventories finds no place in an efficiently run concern In addition to losses in falling markets, there is the added possibility that the inventory may become partially or completely obsolete before the next season

In one business where a satisfactory relationship seemed to exist between the current assets and the current liabilities, the banker noted that

borrowings had been steady for three years. An examination showed that the inventory, particularly work-in-process, constituted a large part of the total assets. The auditor who had prepared the balance sheet had stated in the typical manner that the inventory had been certified by a responsible member of the management staff. The loaning officer of the bank had at first accepted this assertion without comment, but subsequent study revealed that the inventory was actually 45 per cent overvalued. Some items were ten to fifteen years old and absolutely worthless. Thousands of dollars' worth of the merchandise could not even be located. Some goods had been out on consignment as long as five years, and in all but one case the concerns to which the goods had been consigned were either bankrupt or out of business.

The retailer has a peculiar inventory problem. In some retail stores a substantial percentage of the annual sales is transacted on a small percentage of items. Many of the items are slow-moving and non-profitable. In the most successful independent store in a middle-western city—a store that was carrying forty-nine classes of goods, such as groceries, hats, shoes, and hardware—66⅔ per cent of the classes of merchandise was sold at a loss. One progressive merchant sensed this inventory problem and gradually eliminated three out of five items from his inventory. Some of the slow items were replaced by faster-moving numbers, but his final inventory was 32 per cent less than the original one. By this method he reduced his inventory investment 8 per cent, increased sales 20 per cent, and added 50 per cent to his net profits.

In an Ohio town another retail merchant demonstrated extraordinary results in inventory management. He classified his merchandise, measured the turnover of each class, and determined his costs for each line. Some lines were costing four to sixteen times as much rent as more profitable numbers. As a result of his ingenious, but practical analysis, he reduced the space occupied by one class of goods on one counter near the front of the store by 66 per cent and in the vacated space displayed faster-moving lines. This progressive retailer kept watch on his different tables of merchandise, shuffled and shifted, eliminated the drones, and gave the workers better display. That business has made steady progress.

Production Management

The third difference between successful and unsuccesssful management applies only to manufacturing enterprises. This difference has to do with increasing efficiency and reducing costs in a production program. A

steady stream of accomplishments has improved production methods ever since the beginning of the industrial revolution

A manufacturer, who was not naturally a clear headed and decisive manager, noticed that his sales were beginning to decline in a favorable market, but was unable to determine the cause Finally, he employed an assistant with full authority to investigate and reorganize operations The outsider immediately found that general working conditions were bad, that plant operations were scattered over several blocks, and that buildings were ill suited for their functions The equipment was old and involved heavy maintenance expense The flow of work was uneven, and traffic jams upset the process line The concern, however, was employing a high type of labor which was doing its work with an excellent spirit, from the president down to the freight handler While many operations were noticeably inefficient and costly, the workers were all eager to improve their record, if only the management would show them the way

That spirit in itself made up for many blunders, enabling this corporation to reverse its unfavorable trend within a period of two months. Delays in the flow of work were eliminated A slight expenditure for new equipment remedied the most glaring mechanical defects Processes and systems were rearranged in a manner that sped up the work In three months production increased 25 per cent with an expenditure of only $6,000 for new equipment

Almost immediately the management found itself out of the red In two years the earnings reached a point that made possible the erection of a new building and a further reduction of 20 per cent in production costs over their best previous year As a result of open minded, progressive management, the production costs were cut in half and the business became unusually profitable This is what may be accomplished when management is realistic regarding its problems, its needs, and the value of a competent, trained point of view

New Developments and Change

The fourth difference concerns the recognition of the great philosophic truth that permanence lies only in change Styles, customs, and habits are in a constant state of flux, and costly machinery and equipment may have to be scrapped without warning on appearance of a superior invention. Management must be on its toes day and night producing or distribut

ing products that meet the needs of the market. Some new development in machinery or in the technique of production or distribution may change the entire complexion of a business almost overnight.[1]

In one company the introduction of more modern machinery increased production over 100 per cent, with a considerable saving in costs. In another concern a new process doubled production. In an eastern enterprise the management proposed the construction of a new building at a cost of a quarter of a million dollars. At this point a new production manager entered the picture. By changing production processes and methods, he saved one half of an entire floor in the factory, cut production costs at the annual rate of $175,000, and obviated entirely the need for the new building. In still another case a business was about to recapitalize and increase its plant facilities, when a skilled technical engineer joined the executive staff and demonstrated that the existing plant could produce more than twice the output that was currently being crowded through with great difficulty. Some managers are needlessly extravagant, whereas others are efficient, economical, wide-awake housekeepers.

Cost Accounting

The fifth difference between successful and unsuccessful management concerns the ability to utilize cost figures. As a range finder in the previously outlined four points, managements need accurate cost-accounting records so that the various operations and divisions of a business may be measured efficiently and rapidly. A running stream of facts should be available relating to materials, labor, supplies, orders, shipments, overhead, manufacturing, and distributing costs. There is nothing so stimulating to management as the ability to measure actual day-by-day operations and to develop methods of reducing costs and improving efficiency.

[1] A company, which was having unusual success, had just moved into a new plant, paid for in cash. The plant was filled to capacity with business, and the concern had five times as much cash in the bank and ten times as much in assets as every dollar it owed. Yet at the very time this company moved into its new plant, crowded to capacity with business and with $1,000,000 of cash in the bank, some enterprising young mechanic discovered a way of doing exactly the same thing as this company's product at less than one tenth of its cost. It took this company two years to find out that it was actually out of business and would have to employ all of its facilities in finding something entirely new to manufacture. Such a situation may be even more overpowering to labor than to business enterprises. Witness the effect on glass blowers when the bottling machine was introduced and on typesetters when Linotype machines became widely used. The introduction of the ballpoint pen caused the keenest possible competition for sales among leading fountain pen manufacturers.

Marketing Management

The sixth difference has to do with the universal problem of effective distribution If management has found difficulties in dealing with what might be considered the more or less mathematical problems of production, one need not be surprised to find that the difficulties of marketing are even greater The success of management in solving its problems varies with its ability to obtain and interpret essential facts The difficulty in getting adequate facts in the field of marketing and advertising is undeniably great What, for example, does the manufacturer know of his markets, as to both quantity and types of demand—particularly of a new product? What are the trends in style, design, color? Only a few men highly qualified by experience have a perspective on these problems in any one particular field Does the business have an executive who is thoroughly competent to discharge these selling and advertising responsibilities?

Are the selling policies designed to sell those products that are known to meet the least resistance, to yield the largest profits, and to represent the most dependable future? Is the advertising clearly aimed to move the profitable lines? Is the manufacturing schedule adjusted to the sales turnover? How many people can afford the products? How much would the potential market increase with a 10 per cent reduction in the sales price? These are only a few of the questions that the management seeking successful, sustained distribution must answer

Answers to these questions, considered in the light of judgment, experience, and knowledge, will help to construct a more definite and logical marketing program The sales volume will be planned by lines and territories and will keep step with the ability of the market to absorb the merchandise at a proper sales expense New methods of merchandising and new lines of goods should be put through actual tests in restricted territories before they are incorporated into the general sales plan Problems will be solved in miniature, and the principles thereby developed will then be applied upon a general scale

Every banker and business executive has heard much of the possibilities of simplifying lines and of concentrating sales effort upon a limited number of well-chosen items Simplification has been applied aggressively in industry for nearly twenty years with tremendous achievements, but its possibilities have by no means been exhausted Closely coupled with simplification is the possibility of reducing prices Whatever may be the

reason for price reductions, whether manufacturing processes are simplified or other methods of reducing costs are discovered, the result is almost always a surprising increase in the volume of business and in profits.[2]

Test campaigns frequently reveal tremendously increased potential markets when prices have been lowered. In one case a test in five key cities showed that a reduction in price, without impairing quality, would triple both sales and profits. Three fourths of the production at the new price reached markets never before sold by any concern in the field. Thus, a daring initiative based upon a comprehensive test brought to light a new and vastly broader market.

Many concerns have had the feeling that the man in charge of merchandising should be a supersalesman, a persuader *par excellence*. In these rapidly changing times, sound progressive marketing requires a scientific and analytical temperament of a high order rather than a high-pressure salesman. The sales executive must have a gift of perspective, a clear-cut grasp of the importance of net profits, creative instinct, initiative, ability to obtain and interpret figures, and a determination to discover new and better selling methods.

Personnel Management

The seventh difference is concerned with the ability to build an organization and to handle personnel, from production and marketing engineering to human engineering, from the consideration of mechanisms and mathematics to the consideration of men. In the last analysis, successful management shows itself in the teamwork of its employees. Systems and plans are but the rules to be followed in the game in which men are the players. The management of every enterprise must maintain an attitude of judicial fairness and open-mindedness in handling the problems of personnel. Prejudices, unwarranted sentiments, personal animus, and preconceived convictions must be forgotten.

The management is faced with a problem of human engineering, a

[2] The desirability of lower prices to assist in bringing about recovery in direct contrast to higher prices (except at the low point of a depression) was emphasized as one of the fundamental conclusions in a broad study published by Brookings Institution, *The Recovery Problem in the United States* (Washington, D. C.: Brookings Institution, 1936), p. 530. "As output continues to expand and efficiency to increase, prices should be reduced. Even under present conditions it may be desirable in many instances to lower prices as a means of increasing demand and promoting a fuller utilization of productive capacity. The basic principle remains that price reduction, as a general policy, constitutes the surest means of promoting continuous economic progress."

problem of giving the worker everything to which he is entitled and of receiving his best in return In some organizations one finds a tendency to criticize, to overlook or forget achievements, but never to forget errors Constructive management, however, is built upon the principle of sparing unnecessary criticism and emphasizing fine accomplishment

Without the proper spirit among the men, no system or plan will make a business successful With the proper spirit, hardly any plan can long check accomplishment And so one could emphasize this subject of human engineering, which, after all, goes to the heart of successful management

RELATIONS BETWEEN BORROWERS AND BANK

Establishing a Line of Credit

Frequently bank customers, particularly those who borrow in large amounts, request the banker to establish a line of credit—that is, a definite maximum limit up to which they may borrow—instead of making arrangements for a single isolated loan from time to time A line of credit may be established for a definite period of time, perhaps for six months, a year, or a given period of production Such lines of credit are reviewed periodically as they expire, and, at that time, are canceled or renewed for the same or a different amount

Henry Sorenson, for example, was the president of a large corn packing plant in southern Illinois In February or March of each year Mr Sorenson would call at his bank and present a tentative budget indicating the corn acreage that he planned to plant for the coming season He would present tentative figures of the anticipated size of his corn pack, the budgeted cost of corn and labor, the cost of the cans, and other incidental expenses In the middle of August the major part of his borrowing would begin and continue until the last corn was delivered to the plant late in the autumn On the basis of his production estimates and the assumption that the crop would approach the forecast figures, Sorenson would estimate the amount of credit he would need to complete the corn pack A substantial portion was invariably sold in advance, and, judging by past experience, he knew that payment from the buyers of the canned corn would begin within thirty to sixty days after the completion of the pack By the following April he would be out of debt with his bank

To assure himself of adequate funds for these operations during this year, he asked his banker for a line of credit of \$250 000 The banker then examined the balance sheet, operating statement, and budget for the com-

ing year and, satisfied with the financial responsibility, balances maintained, and past record of the business, granted the request for the line of credit. Mr. Sorenson then sent in the notes of his company as the funds were needed. If the crop was smaller than anticipated, only part of the line was used. On the other hand, if the crop was much larger than expected, the banker agreed to an increase in the line of credit. When a definite line of credit is granted in this manner, the banker is morally obligated to fulfill the commitment he has made.

Most business enterprises borrow without obtaining definite lines of credit. They borrow whenever they have need of funds, and they depend upon the bank to make the loan. Well-established businesses which have fairly definite programs of seasonal operation, however, find it a distinct advantage to establish fixed lines of credit in advance of actual needs.

Annual Retirement of Loans

There is what might be termed an unwritten law in banking practice that each borrower retire, or "clean up," his indebtedness at least once a year. This rule is generally applicable but, like all good rules, has its exceptions.

The bulk of the funds that banks have to loan are payable to depositors on demand and, in the case of savings depositors, are payable on short notice. The capital and the surplus of the bank are what might be called permanent funds and are not payable on demand. Although only a relatively small percentage of the deposits need be kept in cash, nevertheless a commercial banking institution can hardly loan the major part of the deposits to private borrowers for such periods as five or ten years. A certain portion of the deposits may be so loaned, but the bank must maintain itself in a reasonably liquid position, so that it can always satisfy the demands of its depositors.

For a number of years paper acceptable for rediscount and as security for advances by the Federal Reserve Banks was required to be of prime quality and of short maturity. A change of policy was made in the Banking Act of 1935. The Federal Reserve Act was amended to allow Federal Reserve Banks, subject to regulations of the Board of Governors, to discount for member banks any commercial or agricultural paper and to make advances to member banks on their promissory notes secured by any sound assets. The certainty of repayment of a loan and its soundness are now given important consideration, whereas formerly shortness of maturity was more strongly emphasized.

However, an especially important reason exists for the customary requirement of an annual clean up of loans The great majority of businesses go through a complete cycle of operations at least once in twelve months In this class are such groups as manufacturers and retailers of men's and women's clothing, farmers, operators of grain elevators, food packers, automobile manufacturers and distributors, and wholesalers of toys. If a banker should extend a loan to a clothing manufacturer to produce summer clothing, he would probably find, if the loan were not paid within a reasonable time after the goods normally should have gone to market, that the merchandise did not sell This would mean a carry over of goods which might be partly or entirely out of style by the time the next season came around

If a packer of corn failed to retire before July a loan made in the previous August, it probably would mean that there had been a carry over of slow inventory The loan might work out satisfactorily if there should be a smaller pack in the succeeding summer Nevertheless, sound banking policy would have required that the loan be retired before the new corn pack made the current inventory a year old Moreover, a big pack in the succeeding year might mean difficulty in moving the old pack. As a rule, therefore, the theory of an annual or periodic clean up is based upon sound fundamentals of loan making

Capital Loans

A moderate portion of the loans of a commercial bank may, however, be made for two, three four, five years, or slightly longer[3] The management of a corporation in excellent financial condition, for example, might decide to build a small addition to one of its factories The cash position of the concern might be such that it could pay for the addition at once, but to do so would reduce its net working capital to the point where it might be handicapped in its manufacturing activities At the earning rate that had been maintained for a period of five years, the concern could reasonably cover the cost for the addition within three years out of earnings In that event a commercial bank might lend a reasonable portion of the funds in this manner, if all other factors were satisfactory A bank cannot, however, furnish permanently the fixed capital required in a business for the purchase of such assets as land and buildings The bank cannot become a partner in the operation and ownership of a business enterprise

[3] See Chapter XVIII

The bulk of bank loans are made to finance self-liquidating transactions, such as the purchase of raw materials which are processed and sold, and the carrying of receivables the proceeds of which pay off the loans. These industrial and commercial loans should be sharply distinguished from investment loans, such as mortgages, bonds, debentures, and serial notes, where the borrowed funds are used to purchase fixed assets. Investment loans are retired not by the sale of the newly acquired assets, but over a period of years out of the earnings of these assets.

At times bankers make commercial loans that later develop all the characteristics of capital loans. The borrower may, for example, be a manufacturer, a wholesaler, or a jobber who expects to liquidate a bank loan by the sale of merchandise. A sharp recession in business or even a local crop failure may result in a substantial portion of the goods remaining unsold, with a consequent inability to liquidate the loan. The situation may become aggravated if the business decline continues or if these is a succession of crop failures. The banker then finds that for all practical purposes he has what may be called a capital loan. A considerable period of time may be required to liquidate the loan under the best of circumstances.

Compensating Balances

Commercial banks and trust companies, particularly those in the larger cities, commonly require a borrower to maintain deposit balances that bear some fairly definite relationship to his line of credit or to his average yearly borrowings. In most banks the deposit requirement is between 10 and 20 per cent. In other words, if the borrower has an established confirmed line of credit of $100,000, the bank balance should normally average between $10,000 and $20,000. These percentages are not hard and fast, but as a rule a customer who maintains an average balance of $100, for example, would hardly be eligible for a loan of $100,000. Other things being equal, a customer who maintains an average balance of $1,000 is not entitled to the same credit as a depositor with an average balance of $10,000. Such a customer has not contributed as much to the loanable funds of the bank as the depositor with the larger balance.

The rule for compensating balances varies somewhat under different circumstances. If the banking system of the country has a large amount of excess reserves, and if little demand exists for commercial loans, bankers will not be so strict in the application of the requirement for adequate balances. In a period of *easy money* there is less need to hold

strictly to any tacit requirement But in a period when the demand for loans is great, there is a natural tendency to hold more closely to the general policy of compensating balances, in order that the bank may meet more fully the demands of all its customers for credit

Subordination Agreements

In some businesses the banker finds that the balance sheet shows obligations due to officers and to directors or possibly to affiliated concerns for money borrowed The balance sheet may not be sufficiently attractive to warrant a bank loan because of this particular indebtedness

Not infrequently the debt arises because the officers in a small corporation agree to leave a part of their salaries in the business to assist in financing its expansion Likewise, the principals in a partnership may withdraw profits and then loan the funds to the business If a concern needs to borrow from a bank, the banker ordinarily feels that the officers should be willing to subordinate their debt to that of the bank's loan. This point of view prevails particularly where the principals have withdrawn exceptionally large sums from the business—sums that were basically needed for its operation and development—and then turned around and made themselves debtors of the business by loaning these same funds, and to that extent placed themselves on a par with other creditors The banker then would generally assume that the interest of the principals in the success of the business should be sufficiently great to warrant a subordination of any such indebtedness to the loan being requested from the bank.

There are also situations where a small corporation may have borrowed from individuals in its community, possibly relatives of the officers If the corporation needs additional short-term working funds, and if its financial position without subordinating such indebtedness is not particularly strong, the banker may ask that the debt be made junior to the bank obligation A bank loan, which assists the business to operate more profitably, helps all the individuals who have made loans to the business In return for this assistance, the obligations to the individuals are necessarily subordinated until the bank debt has been paid in full To accomplish these objectives, a form of subordination agreement is prepared[4] which is signed by those individuals to whom the business is indebted When the bank debt is retired, the agreement is canceled

[4] See Chapter XXII

Unwarranted Withdrawals or Dividends

Occasionally a business enterprise in healthy financial condition weakens its position by the payment of excessive dividends or by large withdrawals, possibly in the form of salaries to its principals. In cases where the business is indebted to a bank and then weakens its financial position by excessive dividends or withdrawals, the banker will naturally protest vigorously. He may also require definite assurance, perhaps in writing, that such payments in the future will not exceed a certain amount or, possibly, will cease entirely until the bank debt is paid. In extreme cases a business may become so weakened from an unwise dividend policy as to require reorganization. When a concern is not especially strong, the banker may require, before granting a loan, that a definite limit be placed upon dividends or withdrawals.

For example, a medium-sized bakery, located in Philadelphia and owned by five brothers, borrowed from time to time from its bank. Without advising the bank officer in charge of the account, all of the brothers began to take much larger monthly salary withdrawals. Seven months later, when the banker received the new balance sheet, he immediately noticed that net working capital had been substantially reduced, reflected largely in a decline in the cash. He investigated and found that each of the five brothers had invested his increased salary withdrawals in the stock market. At that time the bank's loan was practically retired. Before making any new loan to the business, the banker required a statement in writing, signed by each of the five brothers, that the salaries of the principals would be reduced to their former figures and that no increased salaries would be paid to the officers without the bank's permission during the period any indebtedness to it was outstanding. The five brothers were also requested personally to guarantee the loan and to pledge listed securities as collateral to their guaranties. After the net working capital had been restored through earnings to its former proportion, the banker again made unsecured loans without requiring that the guaranties be secured by the pledge of collateral.

Guaranties

The principal owners of closely held corporations are customarily required to guarantee bank loans made to the corporation. If one person.

for example, owns 85 per cent of the common stock of a corporation, the business in a large measure assumes the characteristics of a sole proprietorship, except that his liability is limited to his investment Similarly a corporation owned almost entirely by two, three, or four persons is not wholly unlike a partnership, except that the owners avoid the joint and several liabilities of general partners Consequently, the banker usually requires that the principal owners of the stock of a closely held corporation personally guarantee loans to the corporation

In the illustration just given, the banker felt, when the loan was first made, that the corporation was a thoroughly satisfactory credit risk without requiring guaranties from the principals Later experience indicated that it would have been much better to require the guaranties at the beginning The brothers would then have known that they were personally liable for the debts of the corporation, and they might have been more reluctant to make large withdrawals which weakened the financial condition of the business

Guaranties are also required when loans are made to concerns whose financial standing does not warrant the extension of straight, unsecured bank credit The business may be a new enterprise which has not yet demonstrated its ability to operate successfully A man of wealth may guarantee a bank loan for some young man, possibly his son or a son in law, who is establishing a new venture He may even request the banker not to advise the borrower that the guaranty has been given, in order to place the borrower on his own responsibility as much as possible

In contrast to these situations there may be a business that has operated successfully for years but has latterly suffered losses The net working capital may have been reduced to such a low point as not to warrant the amount of emergency credit needed The principal owners may offer to give their personal guaranties to induce the banker to grant the required credit Such a guaranty is usually accompanied by a financial statement of the guarantor Sometimes this statement is merely in the form of a letter signed by the guarantor, notifying the bank that the guarantor's net worth is of a certain amount But, as a rule, the banker should require a more detailed statement of the guarantor's assets and net worth the better to evaluate the guaranty In some instances, as we have seen, the guarantor pledges collateral with his guaranty

To obtain additional protection for a loan, the banker may require a guaranty, such as that illustrated in Figure 64, or as explained in Chapter XXII, or he may merely ask that the note itself be indorsed by the guarantor The latter procedure is not difficult when only one individual

is required to indorse. This method is less convenient, however, if there are a number of guarantors living in different communities, and the note must be sent to each of them for indorsement before each new loan or renewal. For such situations, the guaranty form is preferable to the in-

Figure 64 Form of Full Guaranty of The First National Bank of Chicago

GUARANTY DE

The undersigned hereby requests THE FIRST NATIONAL BANK OF CHICAGO (herein called the "Bank") to give and continue to give______________________________

____

(herein called the "Borrower") credit, as the Borrower may desire and the Bank may grant, from time to time, whether to the Borrower alone or to the Borrower and others, and in consideration of any credit given, the undersigned hereby absolutely and unconditionally guarantees prompt payment when due and at all times thereafter of any and all existing and future indebtedness and liability of every kind, nature and character (including all renewals, extensions and modifications thereof) from the Borrower to the Bank, howsoever and whensoever created, or arising, or evidenced, or acquired, and the undersigned waives notice of the acceptance of this guaranty and of any and all such indebtedness and liability The undersigned hereby waives presentment, protest, notice, demand or action on delinquency in respect of any such indebtedness or liability, including any right to require the Bank to sue or otherwise enforce payment thereof

This guaranty is made and shall continue as to any and all such indebtedness and liability of the Borrower to the Bank incurred or arising prior to receipt by the Bank of written notice of the termination hereof from the undersigned, without regard to collateral, or security, or guaranties, or other obligors, if any, or to the validity or effectiveness of any and all thereof, and any and all such collateral and security and guaranties and other obligors, if any, may, from time to time, without notice to or consent of the undersigned, be sold, released, surrendered, exchanged, settled, compromised, waived, subordinated or modified, with or without consideration, on such terms or conditions as may be acceptable to the Bank, without in any manner affecting or impairing the liability of the undersigned It is agreed that the undersigned's liability hereunder is several and is independent of any other guaranties at any time in effect with respect to all or any part of the Borrower's indebtedness to the Bank, and that the undersigned's liability hereunder may be enforced regardless of the existence of any such other guaranties

This guaranty shall also bind the heirs, personal representatives, successors and assigns of the undersigned and shall inure to the Bank, its successors and assigns.

It is understood that while the amount of credit that may be extended to, and the amount of indebtedness or liability that may be incurred by, the Borrower is not limited, the liability of the undersigned to the Bank hereunder shall not exceed

____

____________________________________ Dollars

CHICAGO, ILLINOIS,__________________19____.

______________________________(SEAL)

dorsement. The guaranty may continue in force until written notice of its revocation is received; or it may run for a certain period; or it may cover only certain notes.

Loans to Officers of a Business Enterprise

It is not unusual for the banker to analyze a corporation, generally one whose ownership is closely held, from which the officers have borrowed funds. Sometimes the officers borrow from the corporation to take care of obligations they owe elsewhere. Sometimes the loans are made to enable the officers to obtain a larger stock ownership in the corporation. In an occasional instance the banker may find officers are living beyond

their incomes and borrowing from the corporation to make up the difference This latter practice is particularly unsound

When the banker finds that loans of this general character are increasing each year and are threatening to assume an unreasonable size, he should investigate the situation carefully Generally loans made to officers by a corporation should be specifically secured by collateral, and some definite program of liquidation should be arranged The banker cannot permit the life of a business to be sapped by a practice in which the profits of an enterprise are withdrawn in steadily increasing loans to the principals Assets of this nature should by no means be included in the "Current Accounts Receivable" when setting up a balance sheet on a comparative statement form, for they have not arisen out of the normal business transactions of a concern, and they are usually liquidated slowly and painfully, if at all

For example, Frederick Husted is the president and principal stockholder in a small printing and bookbinding establishment in New York City The business is about sixteen years old and in its early days was operated most profitably During the past six years, however, competition has been exceptionally keen, and it has become more and more difficult to break even

Ten years ago Husted was drawing a liberal salary As it became more and more difficult to operate profitably he reduced his salary and then began to borrow funds in a very small way from the corporation After six years of difficult operations the balance sheet of the corporation shows an item in the assets of "Due from Frederick Husted" of $8,621 75 During that same period the net working capital fell from $23,421 22 to $15,627 90 In other words, the borrowings of the president just about accounted for this shrinkage

Husted lived in an apartment in the Bronx For several years he had desired to move his permanent residence to a suburb in Connecticut just across the New York State line He had finally located an attractive shore-front property of two acres, improved with a modern hollow tile stucco house, which could be purchased for a down payment of $15,000 These funds he could borrow only from his corporation, which would then increase his loans from the business to $23,621 75

This entire situation was laid before his banker The banker was sympathetic with Husted's personal hopes and ambitions for moving into an attractive country setting, but he cautioned as earnestly as he could against any such move, as the business could not stand it. Additional borrowings of $15,000 would reduce the net working capital to the

nominal figure of $627.90, and the concern then would be able only to limp along by borrowing against its receivables from a specialized finance company if such arrangements could be made, by paying bills 60 to 120 days slow, and possibly by borrowing some additional funds on chattel mortgages. Under such a changed financial picture the bank would no longer be able to loan to him on any basis. After careful consideration Husted decided to defer his move until his business was more profitable and showed a definite upward trend.

chapter XIV

UNSECURED BANK LOANS

THE DECISION OF THE EXPERIENCED LOANING OFFICER IN PASSING upon a particular loan or line of credit must always involve a painstaking appraisal of each of the three major divisions of all credit information

1 Antecedent information regarding those who comprise the operating management of the business enterprise and the actual record of the business enterprise, itself

2 Investigational facts covering other bank relations and representative trade relations

3 Financial information, both current and over a period of years

Thorough analysis involves not only a careful study and an intelligent workable understanding of the basic financial condition of the prospective borrower, but also a capacity to grasp the natural ability or inability of the borrower to liquidate the indebtedness according to terms

No rule-of-thumb method may be prescribed for the procedure to be followed leading up to the final decision, except that the credit investigation and subsequent analysis must without exception comprehend all available information. Moreover, the analysis, to be fundamental, must cut beneath the surface of the figures and reveal the actual, in contrast to the apparent, condition of the enterprise seeking credit Confidence in the operating ability of the borrower may have been so well established by previous satisfactory relations as to preclude the necessity of anything but a careful inquiry into the purpose of the loan and the time of repayment, accompanied possibly by an oral statement of the prospective borrower's current financial condition or of the changes that have taken place in the assets and the liabilities since the issuance of the last fiscal balance sheet

On the other hand, consideration of a request for credit from a new company or "borderline" case, or a loan sought to finance an expansion program, may require a searching inquiry into all phases of the customer's operations, a study of projected balance sheets and of detailed operating and cash budgets to determine how and when the loan normally would be liquidated. A commitment for several hundred thousand dollars to finance a season's production of a manufacturer whose financial condition discloses no reserve obviously would present a much more complex problem than a sixty-day loan of a few thousand dollars to an enterprise of moderate size, but in liquid position, for the purpose of completing actual confirmed orders on the books.

It is the function of the loaning officer to satisfy himself with reasonable certainty that the borrower will be in a position to liquidate the newly incurred obligation in accordance with its terms.

> The officer in charge of loans and loan applications must be a good judge of character and have keen analytical powers to discern the type of individual making an application for credit. He must then be able to analyze all factors pertaining to the loan applied for, first, as to its basic safety and the ability of the borrower to repay according to the terms of his contract; second, as to the liquidity demonstrated by the borrower's balance sheet in the type of assets, both current and fixed, which constitute those assets; third, not only as to the current operating statement, but also as to the operating statements of previous years in order that the trends of the business may be fully understood. Every extension of credit and every loan must be made with a view to profit, both to the bank and to the borrower. The successful and constructive banker should always recognize two major factors in extending credit: first, when a loan is granted, provision must be made at the same time for its repayment; and, second, the transaction must be one in which the borrower profits by the use of the credit as well as the banker by the income which he receives from the loan.[1]

To enlarge upon the principles of credit extension and practical statement analysis already discussed, this chapter presents five actual cases illustrating the procedure by which loan officers establish and then appraise the variety of facts that are essential in arriving at sound credit decisions. The illustrations are given in considerable detail, omitting no important aspect of the typical request for credit which comes to the bank officer's attention. The examples begin with less complicated loan requests and proceed to cases that are more complex and involve larger amounts.

[1] Statement of H. E. Cook, former chairman of the board, Federal Deposit Insurance Corporation.

ANALYSIS OF FAVORABLE BASIS FOR SMALL LINE OF UNSECURED CREDIT

The first illustration is a request for an unsecured loan of $3,000 made by an established retailer of furniture and home furnishings operating in a little city of fifty-five hundred inhabitants located in a prosperous dairy county in western Wisconsin. Within a radius of eight miles are settled fifteen hundred farmers who do their trading and purchase their salt and pepper, their coffee, their gasoline, and all their groceries almost exclusively in this city.

Antecedent Information

John Hilton, the sole owner of the store, started the enterprise over thirty-five years ago and has operated successfully since that time through fair weather and foul. He is well known to Henry Anderson, president of the First National Bank. Mr. Hilton is an efficient organizer, a sincere, hard worker, and a capable manager. He began the business in a small way with practically no capital, and in the thirty-five years that the store has been in existence, he earned sufficient profits to finance the erection of the modern two-story brick building in which the store is located and to purchase three adjoining, two-story, brick-front store structures, which are leased to other retailers. In addition, he owns a modern, seven-room residence, with a current market value in the neighborhood of $10,000. All are free of debt.

Investigational Facts

Mr. Hilton has always discounted his merchandise bills and has maintained an excellent record throughout the trade. The last investigation completed by the bank five weeks ago in anticipation of this particular seasonal request for a loan, was made with twelve sources of supply. Recent high credit reported by these suppliers ranged up to $1,330, sales in every case being made on regular terms, and payments were prompt or discounted. A current report from Dun & Bradstreet, Inc., received under continuous service three weeks ago, also carried uniformly favorable trade experiences. It had been Hilton's practice to borrow $2,500 to $4,000 late each fall, and every loan so made had been retired in the following January before the actual due date.

Financial Information

In November Mr. Hilton decided to increase his inventory for the holiday season, and so made his usual request for credit at his bank, this time for a loan of $3,000 to run ninety days. He presented a brief and simple financial statement in round figures (see Figure 65) showing his assets and his liabilities as of the end of the preceding month:

Figure 65 Financial Statement of the Hilton Furniture Store (*October 31, 19–*)

Assets		
Cash	$ 1,020.00	
Receivables (All bad and doubtful receivables written off)	3,000.00	
Inventory	7,000.00	
Current Assets		$11,020.00
Furniture Store Building, after depreciation	$ 8,000.00	
Other Buildings, after depreciation (Home valued at $10,000 not included)	23,000.00	
Fixed Assets		31,000.00
Total Assets		$42,020.00
Liabilities		
Accounts Payable	$ 1,200.00	
Accrued Expenses	105.00	
Current Liabilities		$ 1,305.00
Net Worth		40,715.00
Total Liabilities and Net Worth		$42,020.00
Net Working Capital		$ 9,715.00
Current Ratio		8.44
Net Sales for Ten Months		$33,000.00
Net Profits for Ten Months		4,045.00

The financial statements dated December 31 for each of the three preceding years presented substantially the same healthy condition as this interim balance sheet. The net worth during those three years had, however, increased only $1,000 to $1,500 during each year. During the first ten months of the current year, the net worth had been increased by profits to the extent of $4,045. The current year would be the most successful one in his history.

Around 60 per cent of the net sales are charge accounts made on terms calling for payment at the end of the month. About one third of the annual sales are for cash. Little merchandise is sold on the instalment basis. As a result, the current figures show a fairly satisfactory average collection period of forty-one days.[2] The inventory is turned over rapidly

[2] The average collection period is arrived at in the following manner: About 60 per cent of the sales are on charge accounts and 7 per cent on the instalment basis,

and total current liabilities are nominal The financial condition of the enterprise is exceptionally strong a characteristic condition for many years Moreover as the business is a proprietorship, the entire outside means of the owner would add additional support to any borrowings.

The Decision

In view of the satisfactory experience of the bank in previous years, the long record of successful operation of the business, the high reputation of the owner the uniformly favorable manner in which merchandise invoices are paid the attractive current ratio, and the additional security afforded by the depositor s outside property, the banker was pleased to grant the loan

This illustration is typical of thousands of small loans requested and granted daily in thousands of communities in every state in the Union.

ANALYSIS OF UNFAVORABLE BASIS FOR SMALL LINE OF UNSECURED CREDIT

Jordan Stone is a young man who is employed as a salesman for an established local printing house He and a friend, Verne Smith, who was graduated from college five months ago and is employed in the sales department of a wholesale grocery company, approached Walter Lewis, an officer of the Arden National Bank, Milwaukee, for an unsecured loan of $1,000 to be made to the Excel Candy Company

Antecedent Information

These two young men had investigated the business of one James Burns, who had manufactured without success a sugarless candy for a period of about two years and had recently closed his shop They explained to Mr Lewis that Burns had had a fairly good little business, that his product had unusual merit and a definite sales appeal, but that through personal negligence—the fact that he would arrive at the factory late in the morning and leave early in the afternoon, that he had developed no aggressive sales program or intelligent control over expenses—he had

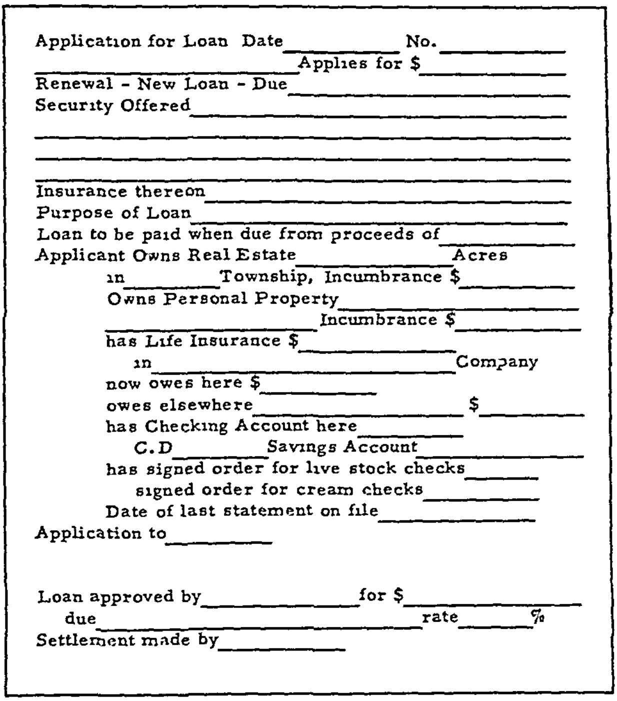
a total of 67 per cent representing credit sales This 67 per cent of the $33,000 sales for the ten months gives $22 110 which represents the net credit sales for the ten months This figure divided by 304 days (10 months) gives credit sales of $73 per day If $73 is then divided into the receivables shown on the balance sheet at $3,000 the result is 41 days which is the average collection period

failed to make a success of his opportunity. Finally, Mrs. Burns, his wife, had offered to sell the idle machinery for $500.

The equipment was located in small rented quarters in the factory building of a local food manufacturer.

Messrs. Stone and Smith had been assured that they could rent the quarters in which the machinery was stored for $30 monthly. They had

Figure 66 Application for Loan Form of a Bank in a Farming Community



Application for Loan Date________ No.________
____________ Applies for $________
Renewal - New Loan - Due____________
Security Offered____________
Insurance thereon____________
Purpose of Loan____________
Loan to be paid when due from proceeds of________
Applicant Owns Real Estate________ Acres
in________ Township, Incumbrance $________
Owns Personal Property________
________ Incumbrance $________
has Life Insurance $________
in________ Company
now owes here $________
owes elsewhere________ $________
has Checking Account here________
C.D________ Savings Account________
has signed order for live stock checks________
signed order for cream checks________
Date of last statement on file________
Application to________

Loan approved by________ for $________
due________ rate________ %
Settlement made by________

also obtained tentative orders from friendly wholesalers and retailers for $250 of the candy. An analysis by a reputable chemist showed that the product contained certain ingredients that would be helpful in carrying on an intelligent advertising campaign. Furthermore, the candy contained absolutely no sugar, a most favorable feature in making the product attractive to women, children, and diabetics. In fact, the confectionery buyer in a leading department store in Milwaukee had said that the candy sold exceptionally well to women, and he had indicated his desire to restock a moderate quantity as soon as the candy was again manufactured.

Neither one of the young men had had any experience in this line, but

they explained that they could hire the operator who had been employed formerly to mix and produce the candy. Stone had had some selling experience, while Smith had still to demonstrate his business ability.

Financial Information

The machinery, as indicated, would cost \$500, and the necessary raw materials to begin manufacture would cost from \$300 to \$400. Additional funds would be required for containers and wrappers, initial advertising, and other expenses of developing the business. Since the concern would extend the usual thirty-day terms of credit to its customers, additional funds would be tied up in receivables. At least several months would be needed to establish operations on a profitable basis. In the meantime, rent and the salary of the candymaker would need to be paid. In addition, Smith expected to resign from his present position to sell the candy and to manage the business. He would need a moderate drawing account to support himself.

The banker was sympathetic with the desire of these two young men to launch their own business venture. However, neither one of them had assets of any kind that could be used as collateral for a loan. Moreover, they had no particularly close friends who would endorse their note, guarantee the loan for them, or furnish collateral. The principal asset the bank would have in the event the business did not succeed would be the used machinery which cost \$500. Mr. Lewis, the banker, also thought the business would need substantially more than the \$1,000 requested in order to purchase the machinery, the requisite raw material, containers, and advertising matter; carry the receivables until collected; and pay the salaries, rent, and other incidental overhead expenses until the business became a going concern—that is, until income exceeded expenses.

The Decision

In view of the inherent hazards of the undertaking and the fact that neither Stone nor Smith owned assets of any kind, Mr. Lewis felt impelled to decline their request for an unsecured loan.

ANALYSIS OF FAVORABLE BASIS FOR MODERATE LINE OF UNSECURED CREDIT WITH ENDORSEMENT

The Kirkpatrick Machine Works, Inc., had carried a non-borrowing account with the Second National Bank of Cleveland for six years. In

May, C. C. Kirkpatrick, president of the company, called on Alvin Bronson, assistant vice president of the Second National Bank, and sought a loan of $10,000 to enable the company to complete current unfilled orders received from four nationally known corporations and amounting to approximately $50,000.

Antecedent Information

In the credit file of the bank Mr. Bronson found the following memorandum which was dictated by Fred D. Herrick, a member of the business extension department, following a call at the plant of the concern in January.

I made a good-will call at the office of this company today and met Mr. Kirkpatrick. Their deposit account averaged $15,000 last year and $27,600 during the previous year. Mr. Kirkpatrick, a man about forty years of age, became the sole owner of the business when his father died two years ago. The concern, which was incorporated after the death of the elder Mr. Kirkpatrick, has made machinery for the cooperage business for a long period of years. A side line of machinery for making automobile and truck tire rims has also been developed. The corporation holds about thirty basic patterns on these different machines and sells the product to most of the automobile tire manufacturers. Recent orders from one domestic customer, Weston & Kirk, Inc., and from England are for more than the entire volume handled last year.

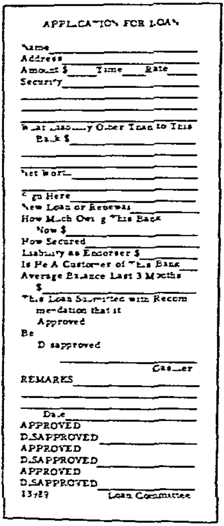
The corporation also has an up-to-the-minute machine shop equipped with large machinery for planing and finishing heavy castings and, at the time of my call, had fifty-four tons of large castings on the floor to be finished and delivered to fill actual orders. Machinery and equipment costing over $55,000 have been depreciated to about $8,000. After taking depreciation of 10 per cent, the operations just about broke even for year A (a difficult year for the machinery business). The concern owns valuable patents on special machinery, however, and is in a position to profit materially by any increase in sales.

The business has not borrowed for several years. Mr. Kirkpatrick appears capable and conservative. He is somewhat of a mechanical genius, as he developed several of the machines which do the precision work. He also runs the office and handles the finances. The one weak point in this interprise is its one-man control, for any accident to Mr. Kirkpatrick would seriously handicap the business. He told me that he was very well satisfied with our services and evidently was appreciative of the interest evidenced by my call.

Financial Information

As this brief picture of the operations served to provide the necessary background, the banker proceeded to inquire into the current financial situation, the working capital position, and the prospects of the business

Figure 67 Application for Loan Form of a Bank in an Industrial Community



APPLICATION FOR LOAN

Name ______
Address ______
Amount $ ______ Time ______ Rate ______
Security ______

What Liability Other Than to This Bank $ ______

Net Worth ______

Sign Here ______
New Loan or Renewal ______
How Much Owing This Bank Now $ ______
How Secured ______
Liability as Endorser $ ______
Is He A Customer of This Bank ______
Average Balance Last 3 Months $ ______
This Loan Submitted with Recommendation that it Be Approved / Disapproved

______ Cashier

REMARKS ______

Date ______
APPROVED / DISAPPROVED ______
APPROVED / DISAPPROVED ______
APPROVED / DISAPPROVED ______
13789 Loan Committee

for the next few months Mr Kirkpatrick gave the following approximation of the working capital position of his business as of May 9

Cash	$ 8,935	
Accounts Receivable	24,500	
Inventory	18,000	
		$51 435
Accounts Payable	$ 7,315	
Taxes and Accruals	425	
		7,740
Net Working Capital		$43,695

He also informed Mr. Bronson that the corporation had billed approximately $100,000 since January 1. This more than doubled the net sales of $46,456 during the entire fiscal year ended October 31, year A (page 314), on which a net loss of $353 was sustained. The balance sheet as of October 31, year A, which was the only financial statement in the credit file, disclosed a satisfactory working capital position, with current assets of $32,868, current liabilities of $4,008, and a net working capital of $28,860.

After studying these figures briefly, the banker informed Mr. Kirkpatrick that his request for a loan appeared to be reasonable, but that for purposes of comparison he would like to have access to the two preceding year-end balance sheets and a balance sheet together with a profit and loss account as of April 30, year AA. In the meantime he would also have an investigation made in trade quarters. In view of the fact that as of October 31, year A, the tangible net worth amounted to only $26,343 and that the management of the business devolved entirely upon Mr. Kirkpatrick, he was asked to endorse the company's note, if the loan were granted. He agreed.

Fluctuation in Tangible Net Worth.—A few days later Mr. Kirkpatrick brought in copies of the three balance sheets requested, together with a profit and loss statement for the six months ending April 30, all of which had been prepared by an independent firm of certified public accountants. All of these figures, a part of which are shown in detail in Figures 68 and 69, were then set up on a comparative statement form (Figure 70), and the trend was analyzed. The analysis revealed that the real estate and the plant (the net value after depreciation being $23,391) had been withdrawn from the partnership sometime in year B, and that this withdrawal, coupled with a loss of $4,067 and cash withdrawals of $8,292, had reduced the tangible net worth from $88,748 to $52,998. These assets had been conveyed to Mr. Kirkpatrick's father, whose death in the latter part of year B had made it advisable to incorporate the business.

The further decline in the tangible net worth to $26,343 in year A had been occasioned principally by retiring 111⅑ of the 250 authorized and then outstanding shares of capital stock, at a cost of $25,000. The corporation's notes due in three and one half years, given in payment of the full amount, had been reduced by payments to $13,325 by October 31, year A, and stood slightly lower at $13,132 as of April 30, year AA. As these notes were to mature more than a year subsequent to the respective statement dates, they were considered deferred liabilities.

Current Condition.—Mr. Bronson noted that a thoroughly satisfactory

Figure 68 Balance Sheet for Kirkpatrick Machine Works, Inc

(Year AA)
April 30 19__

Assets			
Current Assets			
Cash			
Second National Bank	$ 9 278 27		
Petty Cash	5 05		
		$ 9 283 32	
Trade Accounts Receivable	$16 492 08		
Less—Reserve for Bad Debts	1 856 65		
		14 635 43	
Inventories as taken and priced by the management			
Finished Machinery	$15 733 82		
Work in Process	13 082 71		
		28 816 53	
Unexpired Insurance Premiums		255 35	
Current Assets			$52 990 63

Machinery Tools Fixtures and Automobile

Particulars	Cost	Reserve for Depreciation	Net Book Value	
Machinery and Equipment	$53 365 70	$46 008 84	$ 7 356 86	
Tools	10 762 00	9 371 14	1 390 86	
Office Furniture and Equipment	1 807 85	1 625 86	181 99	
Automobile	350 00	262 50	87 50	
Totals	$66 285 55	$57 268 34	$ 9 017 21	9 017 21
Total Assets				$62 007 84

Liabilities and Net Worth

Current Liabilities				
Trade Accounts Payable			$7 289 41	
Accrued				
Salaries and Wages			377 95	
Expenses			204 00	
Interest			375 00	
Real Estate and Personal Property Taxes (Estimated)			1 010 56	
Ohio Sales Tax			54 10	
Provision for Federal Income Taxes (Estimated)			4 500 00	
Current Liabilities				$13 811 02
Other Liabilities				
Notes Payable Balance of $25 000 issued to retire 111 1/9 shares of stock of the corporation due in three and one half years or prior thereto at the option of the corporation				13 131 72
Net Worth				
Capital Stock Authorized 250 shares par value $100 issued and outstanding 138 8/9 shares			$13 888 89	
Capital Surplus			14 108 68	
Earned Surplus				
Deficit November 1 Year A	$ 1 653 32			
Net Profit for six months ending April 30 Year AA	10 670 85			
Dividends	1 950 00	7 067 53		35 065 10
Total Liabilities and Net Worth				$62 007 84

current position had been maintained during the entire period covered by the statements, and that the April 30, year AA, balance sheet indicated current assets of $52,735 to pay current liabilities of $13,811, a liquid condition giving a net working capital of $38,924. The current assets were 3.82 times as large as the current liabilities, which gave a splendid

Figure 69 Statement of Profit and Loss for Kirkpatrick Machine Works, Inc. (*six months ending April 30, 19— year AA*)

Particulars		Amount
Net Sales of Machinery and Parts		$36,399.21
Cost of Sales		16,829.04
Gross Profit from Sales		$19,570.17
Ratio to net sales--53.77%		
Selling and Administrative Expenses.		
Officer's Salary	$2,075.00	
Office Wages	501.70	
Legal and Auditing Fees	238.75	
Ohio Sales Tax	241.92	
Freight and Cartage on Sales	158.09	
Traveling Expense	132.78	
Advertising	117.76	
Telephone and Telegraph	103.82	
Office Supplies and Postage	102.46	
Automobile Expense	62.66	
Depreciation--		
Automobile	87.50	
Office Furniture and Equipment	23.34	
Insurance on Life of Officer	102.80	
Miscellaneous	105.63	
Total Selling and Administrative Expenses		4,054.21
Ratio to net sales--11.14%		
Net Operating Profit		15,515.96
Ratio to net sales--42.63%		
Other Income and Expenses:		
Discounts Received	29.89	
Interest Paid (Deduct)	375.00	345.11
Net Profit for Six Months Before Estimated Income Taxes		$15,170.85
Less: Provision for Estimated Income Taxes		4,500.00
Net Profit for Six Months Ending April 30, 19 (Year AA)		$10,670.85

margin of protection to creditors. Moreover, net working capital had been augmented during the six months period chiefly through profits of $10,671, after provision for estimated income taxes of $4,500, all of which, except for dividends of $1,950, had been retained in the business. The total inventory of finished merchandise, work in process, and raw materials was somewhat heavy, but that condition was accounted for by the rather substantial orders on hand and in process. Current liabilities were incurred solely for the purchase of raw materials and accruals.

Figure 70 Comparative Balance Sheets for Kirkpatrick Machine Works Inc

	Partnership		Corporation	
	(C)	(B)	(A)	(AA)
	Three Years Ago	Two Years Ago	One Year Ago	This Year
	Oct 31 19__	Oct 31 19__	Oct 31 19__	Apr 30 19__
Assets				
Cash on hand and in bank	$4 010	$37 548	$14 806	$9 283
Accounts Receivable Customers	67 569	2 542	12 272	14 635
Merchandise Finished				15 734
Merchandise in Process and Raw Material	1 418	1 724	5 790	13 083
Current Assets	$72 997	$41 814	$32 868	$52 735
Land and Buildings	34 546			
Machinery and Equipment	55 173	55 173	55 173	55 173
Delivery Equipment	1 118	1 118	350	350
Tools	9 175	9 323	10 594	10 762
Deferred Assets	414	475	470	256
Due from Officers and Stockholders	300	300		
Total	$173 723	$108 203	$99 455	$119 276
Liabilities				
Accounts Payable	$16 037	$563	$2 983	$7 290
Accruals	8 642	1 292	1 025	2 021
Provision for Income Taxes				4 500
Current Liabilities	$24 679	$1 855	$4 008	$13 811
Notes due in three and one half years			13 325	13 132
Total Liabilities	$24 679	$1 855	$17 333	$26 943
Reserves for Depreciation	60 296	53 350	55 779	57 268
Net Worth	88 748	52 998		
Capital Stock Common			13 889	13 889
Capital Surplus				14 109
Earned Surplus			12 454	7,067
Total	$173 723	$108 203	$99 455	$119 276
Net Working Capital	$48 318	$39 959	$28 860	$38 924
Current Ratio	2 95	22 54	8 20	3 82
Tangible Net Worth	$88 748	$52 998	$26 343	$39 565
Net Sales	170 412	36 434	46 456	*36 399
Net Profits	(L) 33 833	(L) 4 067	(L)→ 353	*10 671
Dividends or Withdrawals	23 783	31 683	1 300	* 1 950

Statement of Profit and Loss.—For the six months ending April 30, year AA, net sales had amounted to $36,399, which was approximately as large as the volume during the entire year ending October 31, year B, and 78.4 per cent of the volume for the entire year A. The remarkable performance for this six-months period was made possible by a substantial gross profit of 53.77 per cent and moderate selling and administrative expenses, which, including Mr. Kirkpatrick's modest salary, represented 11.14 per cent of net sales. On the basis of orders on hand and anticipated, Mr. Kirkpatrick estimated that his final net profit for the fiscal year would be in the neighborhood of $50,000 before income taxes, which would be a most extraordinary showing.

Investigational Facts

The trade investigation developed highly complimentary information. No restrictions had ever been placed on the account. Purchases among fifteen concerns during the past year had ranged up to $1,450 on regular terms. In ten cases discounts were being taken on discount terms, and in four others, invoices were being paid promptly on net terms. All of the suppliers had been extending credit off and on for many years.

The Decision

In view of the current rate of earnings, the thoroughly satisfactory financial condition reflected in the April 30 statement, the bright outlook for the remainder of the year, and the high opinion held by merchandise suppliers, Mr. Bronson felt that a loan of $10,000 would be amply secured. The banker accepted a ninety-day note of the corporation endorsed by Mr. Kirkpatrick, subject to a renewal for a like period, if desired. He assured Mr. Kirkpatrick that any additional accommodation needed up to $20,000 would be available on the same terms.

ANALYSIS OF FAVORABLE BASIS FOR LARGER LINE OF UNSECURED CREDIT

In February, Charles Clark, the treasurer of the Lincoln Grocery Company, Inc., called on William Hanson, vice-president of the Old National Bank, regarding an unsecured loan of $50,000 for ninety days. Two weeks after its fiscal closing, the corporation had retired its last loan of $84,000, which is shown on the balance sheet for the end of last year. The management planned to use the proceeds of the proposed

$50,000 loan to purchase a substantial supply of canned goods at low prices

Antecedent Information

The Lincoln Grocery Company, Inc, located in a city of forty thousand inhabitants in the state of Georgia, is a closely held corporation transacting a typical service wholesale grocery business Chester O Jorgenson, president, is the principal stockholder, owning 26 per cent of the outstanding capital stock, all common The remaining 74 per cent of the stock is owned by other officers of the corporation and by members of their immediate families The management is experienced, capable, wide-awake, and hard-working The business was chartered in 1895 and has had a continuous, clear record since that time It distributes a complete line of food products, such as canned fruits and vegetables, coffee, olives, spices, preserves, jams, and cereals, within a radius of two hundred miles and is one of the leading concerns in this line in Georgia

Investigational Facts

A recent trade investigation made by the credit department of the bank eight weeks ago indicated high credit of $5,000 on the usual purchase terms in this line of business of 2 per cent discount in ten days, net thirty days The concern was regularly discounting its invoices and had main-

Figure 71A Form of unsecured note (*front*)

$ ________ Philadelphia Pa ________ 19__

On Demand ____ promise to pay

to the order of ________

with interest at the rate of ____ per cent per annum.

Payable at THE PHILADELPHIA NATIONAL BANK

For value received

No ________ ________

tained a most favorable paying record for a great many years Trade investigations conducted at periodic intervals in the past by Dun & Bradstreet, Inc, had shown similar results No restrictions whatsoever were placed upon its credit by merchandise suppliers

The corporation had borrowed moderately from time to time at its one bank, the peak borrowings reaching $85,000 in each of the last three years. These loans generally were outstanding four months of each year, the corporation being entirely out of the bank's debt during the other eight months. The bank balance had averaged between $40,000 and $50,000 for several years and had shown a most satisfactory profit to the depository.

Figure 71B Form of unsecured note (*reverse*)

Philadelphia, Pa ____________

For value received ____________________ hereby waive demand, protest and notice of protest on within note and hold ______________ as duly bound as if same had been legally protested and ________________ had been notified thereof.

___

Financial Information

When Mr. Hanson called for the credit file on the Lincoln Grocery Company, Inc., he found the information complete and up to date. The comparative figures, shown in Figure 72 on page 318, give a clear picture of the financial condition of the business up to and including December 31, less than two months ago. These figures showed fluctuating progress, with the tangible net worth and net working capital down in year B and up in year A, but a healthy financial condition throughout.

The net profits had not been particularly large, ranging from $6,500 in year B to $24,400 in year A. The credit file, however, indicated that the management had operated conservatively and provided liberal allowances for depreciation and for bad debts each year. Profits, moreover, had been shown annually for twenty-five years, which is a most unusual record. Year B is the only year in which dividends had ever been disbursed in excess of the earnings.

Besides operating profitably, the business had maintained a satisfactory current position. Doubtful items had been eliminated promptly from receivables, and the inventory was always fresh and in good condition. Net sales for the last year were at the approximate rate of $100,000 per month; receivables at $67,100, therefore, amounted to less than the sales for three weeks, an unusually fine liquid condition for the accounts on the books.

The inventory at $248,100 was the highest to be shown at the end of

any year in five years and represented a turnover of only 4 7 times, as compared with a typical turnover of 8 times or more in the wholesale grocery field When this heavy inventory position was brought to Mr Clark's attention, he explained that wholesale prices had increased 34 per cent in the last four years and that many of their cocoa, meat, wheat,

Figure 72 Comparative Balance Sheets for Lincoln Grocery Company, Inc (*years ended December 31, 19—*)

	(C) Three Years Ago	(B) Two Years Ago	(A) One Year Ago
Assets			
Cash	$ 44 900	$ 55 200	$ 55 200
Accounts Receivable	64 800	65 200	67 100
Inventory	210 000	200 300	248 100
U S Government Bonds	10 000	10 000	10 000
Current Assets	$ 329 700	$ 330 700	$ 380 400
Land and Buildings Net	75 000	73 000	67 000
Deferred Charges	3 800	5 000	5 300
Total	$ 408 500	$ 408 700	$ 452 700
Liabilities			
Notes Payable Bank	$ 40 000	$ 50 000	$ 84 000
Accounts Payable	1 500	1 700	1 400
Deposits Stockholders	20 000	21 000	20 400
Accruals	11 000	7 500	13 600
Current Liabilities	$ 72 500	$ 80 200	$ 119 400
Common Stock	280 000	280 000	280 000
Surplus	56 000	48 500	53 300
Total	$ 408 500	$ 408 700	$ 452 700
Net Working Capital	$ 257 200	$ 250 500	$ 261 000
Current Ratio	4 54	4 12	3 18
Tangible Net Worth	$ 336 000	$ 328 500	$ 333 300
Net Sales	1 020 000	1 107 000	1 165 000
Net Profits	22 500	6 500	24 400
Dividends	7 000	14 000	19 600

rye, and barley products were selling at the highest point in ten years. He also pointed out that many of their products were produced in other states, and larger stocks of these products had to be kept on hand to avoid running short of any particular commodity.

The principal liability item was the $84,000 note, and that had already been paid to the bank Accounts payable had increased somewhat, but little change had occurred in the accruals "Deposits—Stockholders" of $20 400 in the "Current Liabilities" represented funds that the president and one other officer had placed at the disposal of the business about five years ago They offered to subordinate these obligations to the bank's debt, but the banker was satisfied with the net working capital position and did not require this additional protection Moreover, the company

officials indicated that none of this $20,400 deposit would be paid during the period that the bank loan was outstanding. Likewise, the banker did not require the concern to pledge its holdings of United States Government securities as collateral for part of the loan.

The Decision

In view of the high regard for the management and the efficient manner in which they had operated this business, the thoroughly satisfactory experience the bank had had with the account over a period of many years, the substantial net working capital position, the splendid way in which receivables had been collected and the inventory kept clean, and the excellent record of the concern in the trade, the request for the loan for $50,000 for ninety days was freely granted.

ANALYSIS OF UNFAVORABLE BASIS FOR SUBSTANTIAL LINE OF UNSECURED CREDIT

In February 19—, as the result of previous solicitation by the bank's new business department, Frank T. Burke, the president of the Midvale Electric Company, Inc., of Midvale, one of the larger manufacturing cities in the Middle West, wrote to the Third Bank and Trust Company of Chicago, enclosing a copy of the concern's balance sheet and operating results for the year ending December 31, 19— (summarized as year A in the comparative figures in Figure 73 on page 320). He offered to place a desirable account with that bank contingent upon the receipt of an unsecured line of credit of $200,000. The corporation carried accounts with two Midvale banks which granted aggregate lines of $200,000; this, however, would shortly be reduced to $125,000 with the merger of the two institutions, which were going to establish this borrowing limit for any one customer.

Antecedent Information

Fred T. Vail, the loaning officer of the Third Bank and Trust Company to whom Mr. Burke's letter was referred, called for the credit file on the corporation. The file contained a credit agency report which was slightly more than three months old. This report yielded certain interesting collateral information. The business had been incorporated ten years previously with an authorized capitalization of $100,000. Subse-

quently, authorized capital stock had been increased to $300,000, of which $50,000 was preferred and $250,000 was common Of the preferred stock, only $19 600 was issued Mr Burke was reported to be the principal stockholder, and his business record, his ability, and his experience in the industry were mentioned in favorable terms At this stage Mr

Figure 73 Comparative *Balance Sheets for Midvale Electric Company, Inc (years ended December 31, 19–) (page 1)*

Assets	(D) Four Years Ago	(C) Three Years Ago	(B) Two Years Ago	(A) One Year Ago	(A Revised) One Year Ago
Cash on Hand and in Banks	$ 21 904	$ 83 410	$ 135 086	$ 69 590	$ 69 590
Notes Receivable Customers	6 514	38 760	48 986	295 004	21 91[illegible]
Accounts Receivable Customers	331 938	224 896	479 872	552 654	552 654
Merchandise Finished	40 866			96 500	96 500
Merchandise In Process	86 464	141 682	220 570	103 918	103,918
Raw Material				60 554	60 554
Current Assets	$487 686	$ 488 748	$ 884 414	$1 138 220	$ 904,798
Unlisted Stocks and Bonds		10 000	10 000	10 408	10 408
Building & Loan Assn Stock				101 102	101 102
Cash Value Life Insurance	2 350	3 100	3 850	4 650	4 650
Land and Buildings	166 728	306 256	631 539	892 972	892 972
Machinery and Equipment	206 408	228 334	250 408	309 708	309 708
Automobiles and Trucks	1 564	1 564	1 490	1 820	1 820
Patents Net	64 812	64 808	64 808	73 808	73 808
Deferred Charges	12 720	12 974	14 978	21 222	21 222
Advances		1 956	4 084		
Miscellaneous Notes Receivable	*			87 500	[illegible]
Miscellaneous Accounts Receivable				5 782	5 782
Due from Officers and Employees	7 822	1 100	2 700	10 508	10 508
Treasury Stock		6 800	10 500	10 700	10 700
Total	$950 090	$1 125 640	$1 878 770	$2 668 400	$2 668 400

Figure 73 *(Continued—page 2)*

Liabilities	(D) Four Years Ago	(C) Three Years Ago	(B) Two Years Ago	(A) One Year Ago	(A Revised) One Year Ago
Notes Payable Banks				$ 190 000	$ 190 000
Notes Payable for Merchandise	$111 280	$ 58 364	$ 303 790	118 408	118 408
Notes Payable Individuals				100 000	100 000
Accounts Payable	31 210	46 268	237 204	124,452	124,452
Dividends Payable			364		
Accruals				50 450	50 450
Federal Taxes	80 142	75 184	79 518	39 278	39 278
Total Current Liabilities	$222 632	$ 179 816	$ 420 876	$ 622 588	$ 622 588
Notes to Individuals (Due after One Year)				77 408	77 408
Mortgage Debt Long Term	148 390	225 728	454 844	567 484	567 484
Total Liabilities	$371 022	$ 405 544	$ 875 720	$1 267 480	$1 267 480
Reserve for Depreciation	113 842	154 676	210 880	290 030	290 030
Preferred Stock	19 600	19 600	19 600	19 600	19 600
Common Stock	250 000	250 000	250 000	250 000	250 000
Surplus	195 626	295 820	522 570	841 290	841 290
Total	$950 090	$1 125 640	$1 878 770	$2 668 400	$2 668 400
Net Working Capital	$265 054	$ 308 932	$ 463 538	$ 515 632	$ 282 210
Current Ratio	2 19	2 71	2 10	1 82	1 45
Tangible Net Worth	$400 414	$ 493 812	$ 716 862	$1 026 382	$1 026 382
Net Sales	2 264 416	2 526 354	3 554 480	4 917 200	4 917 200
Net Profits	120 838	113 734	242 574	326 932	[illegible] 932
Dividends	9 068	13 540	15 824	8 212	8 212

NOTE The Tangible Net Worth is determined by adding together the figures representing the outstanding Preferred Stock Common Stock and Surplus and then deducting the intangible items in the assets In Year A, for example the total of the Preferred Stock at $19 600 Common Stock at $250 000 and Surplus at $841 290 is $1 110 390 From this are deducted Patents carried at $73 808 and Treasury Stock at $10 700 in the assets giving the Tangible Net Worth of $1 026 382

Vail's knowledge of the personnel and the record of the concern was from secondary sources and somewhat limited. Additional information and first-hand impressions of a somewhat favorable nature were obtained a few days later when he made a visit to the plant of the Midvale Electric Company, Inc., as described later in this analysis.

Analysis of Latest Balance Sheet

The company had expanded rapidly and had recently undertaken the manufacture and sale of a new electrical appliance in which its own motor was used. This new activity was understood to have required considerable capital, and in some quarters the corporation was reported to be somewhat slow in meeting its merchandise bills, although its account was generally considered satisfactory and desirable. On net sales of $4,917,200 obtained in year A, a final net profit of $326,932 had been earned, representing the unusually high return of 31.85 per cent on the closing tangible net worth and 6.6 per cent of the net sales for the year. The balance sheet had been prepared by a local firm of certified public accountants. The file contained no earlier figures.

Current Financial Condition.—Mr. Vail turned the audited figures received in the mail over to the credit department of the bank for posting on a comparative statement sheet. When the figures were properly posted and the comparative sheet turned over to him, Mr. Vail began to study them, item by item and in their relationship to each other. He observed a current ratio of 1.82 and what appeared to be fairly adequate net working capital of $515,632. Quick assets of a readily liquidable nature—that is, cash and receivables—exceeded current liabilities by $254,660. Inventory, priced conservatively at the lower of cost or market, was in excellent proportion to sales, indicating a most satisfactory turnover. In fact, assuming the closing inventory to be of normal amount, a comparison with the cost of goods sold, $3,665,364, showed an annual turnover of fourteen times, a most unusual and attractive condition.

Receivables.—Throughout the analysis Mr. Vail considered the nature of the company's product, small electric motors ranging in size from fractional to ten horsepower and used chiefly by manufacturers of other equipment. The presence of notes receivable of $255,004 suggested either some deviation from the terms of sale customarily used in this industry or the conversion of past-due accounts receivable into notes. Both explanations pointed to a somewhat lax credit policy. In the event that the notes receivable represented loans to officers or some other transaction

outside of the merchandising operations, they could not be considered a current asset The ratio of sales to accounts and notes receivable indicated a turnover of six times per year and hence an average age of approximately two months This ratio tended to confirm his opinion that a substantial proportion was slow or that receivables not properly current were included in the account.

He also noticed among the deferred assets two items of miscellaneous notes and accounts receivable, one for $87 500 and the other for $[illegible] and among the deferred liabilities, one item of notes payable to individuals of $[illegible]08 Each of these three items required explanation. How did they arise Would the two items in the assets be repaid shortly, or were they likely to remain on the books for a long time? Was the item in the liabilities really a deferred debt, or was it payable within a year? Definite information was needed to classify these items properly and to interpret any effect they might have upon the general financial picture.

Fixed Assets—Land and buildings were carried in the assets at $[illegible], and machinery and equipment at $309,708, a total for these two items of $1 [illegible] 680 After deduction of the depreciation reserve carried in the liabilities, these particular assets had a net depreciated value of $91[illegible]6[illegible]. These assets were pledged, however to secure a mortgage debt, which on the same statement date amounted to $567,484, or more than 50 per cent of the depreciated net value As a result, the fixed assets could hardly be considered of any important supporting value, and the terms of the mortgage debt might possibly be burdensome A detailed study of the provisions of the mortgage would need to be made before setting any definite line of credit The amount of depreciation charged to the year's operations could not be determined definitely from the available operating figures in the absence of a breakdown of manufacturing expense, but the increase in the reserve for depreciation from $[illegible]10 880 to $[illegible]90,0[illegible]0 seemed to indicate that adequate provision was being made for this one important yearly charge

Liabilities—Mr Vail also observed that the total debt, current and funded, of $1 [illegible]6[illegible]480 was top-heavy in comparison to the tangible net worth of $1 0[illegible]6 38[illegible] This condition was attributed to the fact that the company had had an unusually rapid growth[3] The excess of total liabilities over tangible net worth, however, was a dangerous sign.

[3] To an experienced banker an unusually profitable and rapid growth in a business enterprise is often a warning signal that affairs are getting out of line For a discussion of this phase of credit analysis, see Roy A. Foulke *Behind the Scenes of Business* (Rev ed., New York Dun & Bradstreet, Inc., 1952), chap 5

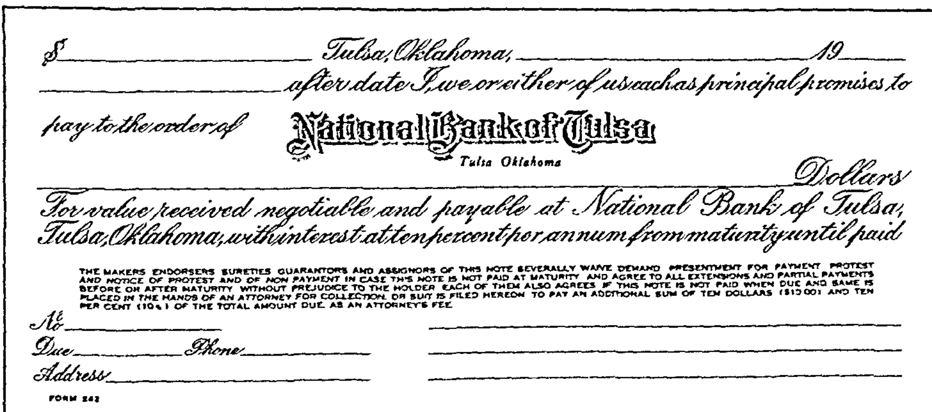
Results of Preliminary Analysis

After this cursory analysis of the information that was on hand and in the credit file, the banker felt that this concern offered possibilities as a desirable credit risk. He therefore wrote Mr. Burke requesting copies of detailed balance sheets and operating statements for the three preceding years, B, C, and D inclusive (see comparative statement summary in Figure 73), the names of the principal sources of merchandise supplies, and a list of the important users of its products. This information was promptly furnished. The bank then had the last four annual financial statements, which were set up on its comparative statement form.

Investigational Facts

Investigations made by the bank's credit department with the seventeen sources of supply whose names had been furnished by the company indicated that discounts were being taken on smaller invoices, but that

Figure 74 Form of a Time Promissory Unsecured Note with Covenant to Pay Attorney's Fee


$ ____ Tulsa, Oklahoma, ____ 19__
____ after date I, we or either of us each as principal promises to pay to the order of National Bank of Tulsa
Tulsa Oklahoma
____ Dollars
For value received negotiable and payable at National Bank of Tulsa, Tulsa, Oklahoma, with interest at ten per cent per annum from maturity until paid

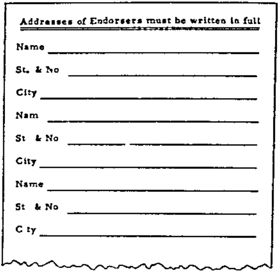
THE MAKERS ENDORSERS SURETIES GUARANTORS AND ASSIGNORS OF THIS NOTE SEVERALLY WAIVE DEMAND PRESENTMENT FOR PAYMENT PROTEST AND NOTICE OF PROTEST AND OF NON PAYMENT IN CASE THIS NOTE IS NOT PAID AT MATURITY AND AGREE TO ALL EXTENSIONS AND PARTIAL PAYMENTS BEFORE OR AFTER MATURITY WITHOUT PREJUDICE TO THE HOLDER EACH OF THEM ALSO AGREES IF THIS NOTE IS NOT PAID WHEN DUE AND SAME IS PLACED IN THE HANDS OF AN ATTORNEY FOR COLLECTION OR SUIT IS FILED HEREON TO PAY AN ADDITIONAL SUM OF TEN DOLLARS ($10.00) AND TEN PER CENT (10%) OF THE TOTAL AMOUNT DUE AS AN ATTORNEY'S FEE

No. ____
Due ____ Phone ____
Address ____
FORM 242

the larger accounts, running as high as $80,000, were being paid partly in cash and partly with ninety-day notes, and in two cases entirely with notes. The notes were invariably met promptly at maturity. All of the suppliers expressed themselves as being entirely satisfied with the account and willing to extend credit for its requirements. Replies received from the principal users of the product were uniformly complimentary, and

it was evident that both Mr Burke and the company enjoyed an excellent reputation

Figure 75 Form Sometimes Used on Reverse Side of a Promissory Note


Addresses of Endorsers must be written in full

Name ____________

St. & No ____________

City ____________

Nam ____________

St & No ____________

City ____________

Name ____________

St & No ____________

City ____________

Analysis of Comparative Figures

An analysis of the annual financial statements as set up on the bank's comparative statement form showed an unbroken record of profitable operations during the past four years and consistent increases in both tangible net worth and net working capital In fact, the tangible net worth had more than doubled during this period and had been financed entirely out of earnings Not only had profits been earned during each one of these four years but they had increased steadily from $120 838 for year D to $326 932 for year A a most impressive showing Only a nominal part of the earnings had been paid out in dividends A substantial portion of the earnings had however been re invested in real estate, buildings machinery, and equipment As a result the enterprise had been forced to increase the mortgage debt from year to year to provide adequate net working capital The financial statement for year D showed a mortgage debt of $148 390 and for year A almost a four fold expansion to $567,484

Net sales had increased sharply during the last two years A current ratio of about 2 to 1 and a fairly comfortable margin of cash and receivables over current liabilities had been maintained from one year to

another. In reviewing this situation in his own mind, the banker was impressed with the upward trend of net sales and profits, but not quite so favorably impressed with the steady increase of fixed assets, mortgage debt, and total liabilities. In other words, here was a situation characterized by some favorable and some rather unfavorable features. He therefore decided to call on Mr. Burke, to review the statements with him,

Figure 76 Form of a Time Promissory Unsecured Note

Due__________ Milwaukee, Wis ,__________ $__________

__________after date, for Value Received, the undersigned promises to pay to the order of

FIRST WISCONSIN NATIONAL BANK OF MILWAUKEE

__________Dollars

at its__________office, with interest at the rate of______percent per annum until maturity,

payable__________and with interest at the rate of 8% per annum after maturity.

Each maker and endorser hereof hereby waives presentment, demand, notice of dishonor, and protest, and consents to any and all extensions of the time or times of payment of this note, without any notice whatsoever. If the undersigned shall be more than one person or corporation, their obligations shall be joint and several, the liability of each shall be absolute and unconditional, regardless of the liability of any other party hereto, and all references to the undersigned herein shall be understood in the plural as well as in the singular and shall be deemed to apply to the undersigned both jointly and severally.

No.__________

F 193-9.3.59

Address

inspect the properties, and obtain a first hand impression of operations and of the executive personnel.

Moreover, the condition of the receivables now appeared to be a more pressing problem, since the comparative figures showed that previous balance sheets carried only a moderate amount in notes receivable. Between year B and year A the amount in notes had jumped from $48,886 to $255,004. A sudden increase such as this in any one item always needs additional explanation. Mr. Vail also reasoned that with total cash and receivables of $877,248 and bank borrowings of $190,000, as compared with total current liabilities of $622,588, the normal turnover of the receivables would logically provide sufficient cash to obviate the necessity of giving notes and should in fact permit the company to discount all raw material invoices.

The Plant Inspection

As soon as he had made his decision to inspect the plant firsthand, the banker called Mr. Burke long distance and made an engagement to visit him at Midvale on the next day. Mr. Vail took a plane from Chicago

to Midvale, arriving early in the morning He met Mr Burke immediately after breakfast and made a careful inspection of the plant. The buildings, although old, were in excellent repair and well protected against fire The plant layout was well adapted to the manufacturing operations. Mr Burke explained that, beginning with one unit purchased for $166 728 in year D, the company had gradually acquired the entire plant, formerly occupied by a now defunct enterprise Balance sheet valuations, which were at cost, appeared extremely conservative, as the plant had been bought considerably below either original or reproduction cost. While a good deal of the equipment had been purchased secondhand, it was in good condition, and the most modern manufacturing methods were employed.

The annual productive capacity based on the operation of three shifts, was estimated at approximately $10 000 000 in net sales Hence, plant facilities provided ample room for expansion in volume Mr Burke reported that the program of plant expansion had been completed and that no additional investment in plant or in equipment was contemplated in the near future The mortgage debt of $567,484, held by a local building and loan association, had been increased to that figure as additional units of the plant had been acquired This obligation was now being amortized monthly, with total payments of principal and interest for the next year amounting to $75 600 or $6,300 per month.

After Mr Vail had satisfied himself, within the limits of his rather general knowledge that the plant facilities were adequate and efficient and that the plant values, as shown on the balance sheet, were conservative, he proceeded to obtain impressions of the executive personnel and of the general operating efficiency of the company Brief interviews with the treasurer, sales manager factory manager, and other executives led to the conclusion that Mr Burke had surrounded himself with a capable organization, as each individual appeared thoroughly conversant with his duties

Operations were budgeted, a comprehensive cost system was maintained, and a close control of expenses was exercised Mr Burke appeared energetic, well informed and amply qualified by temperament and ability to head an enterprise of this size Mr Burke's relations with both executives and employees as the banker observed them, indicated respect and loyalty on the part of the entire organization Mr Burke's primary interest was obviously in sales, and the banker felt that his expressed ambition to build his volume to a dominant point in the industry might possibly lead to overexpansion and other undesirable consequences Mr

Vail also observed that Mr. Burke's complete domination of the company's affairs had tended to curb the initiative of the other executives, with the result that no other man in the organization appeared capable of replacing him if it became necessary. At this point in the interview, however, the banker's general opinion of the management was favorable.

A discussion of the financial statements with Mr. Burke then followed. Mr. Vail was informed that sales were quite diversified. About 90 per cent of the output was taken by manufacturers of equipment, and the other 10 per cent by jobbers or retailers of electrical supplies. Among the customers were seventy manufacturers of pumps, twenty-nine manufacturers of woodworking machinery, seventeen manufacturers of air compressors, eighteen manufacturers of metalworking machinery, and fourteen manufacturers of special machinery. A number of eminent corporations appeared on the list. About one thousand active accounts were reported, and as the largest single customer took less than 10 per cent of the output, the business was not exposed to the risk of having a large part of its volume dependent upon two or three important accounts, the loss of which might materially affect its operations. The banker remarked that a general restriction of output by the equipment manufacturers would be reflected in a drastic decline in the company's volume. Thus far during the current year, sales were running slightly behind those for the corresponding period of the previous year, while unfilled orders on hand were $100,000 less than at the same time last year. Mr. Burke was of the opinion, however, that the year's volume would fall only slightly below, if it did not actually equal, the sales for the preceding year and that operations would result in a satisfactory net profit.

A Critical Study of the Latest Balance Sheet

In the last balance sheet Mr. Vail noted that cash in banks of $69,590 exceeded the customary 15 or 20 per cent required as compensating balances, when compared with total credit lines of $200,000. The account should therefore be profitable for its banks. Furthermore, the building and loan association stock, carried at $101,102, was held in the local company to which the plant was mortgaged, and might not be easy to liquidate for cash.

Receivables.—Reservations as to the character of the notes receivable were then confirmed. Only $21,582 of the total of $255,004 were customers' notes, and these had originated for the most part through devi-

ations from the regular terms of sale Of the remainder, $100,810 consisted of a note of the Simms Manufacturing Corporation of Berkdale, Pennsylvania, manufacturers of filling station equipment, maturing during the current year Another $120,000 represented joint collateral notes of the Simms Manufacturing Corporation and its president, Roger Temple, and were secured by 75 per cent of the outstanding capital stock of the Simms Manufacturing Corporation The remaining $12,612 represented accrued interest This breakdown put quite a different complexion on the size and character of what had been thought were legitimate current assets

The item of $87,500 carried as "Miscellaneous Notes Receivable" represented certain long term notes of the Simms Manufacturing Corporation and was related to the transaction responsible for the notes of Mr Temple and the concern, considered current by the auditors Mr Vail, recognizing in this situation the apparent explanation of the inability of the corporation to take its discounts in spite of what appeared to be adequate net working capital, turned to the detailed audit report He found that these advances had been made to Mr Temple and to his business to permit him to acquire the stock interest of two of his associates who were not in accord with his policies, and to provide that enterprise with working capital The Midvale Electric Company, Inc., had obligated itself for a total payment of $220 408 to the two Simms Manufacturing Corporation stockholders, of which $43,000 had been paid, $100 000 included in current liabilities under the caption "Notes Payable—Individuals," would mature during the current year, and the balance of $77,408, in the following year

The Midvale Electric Company, Inc, had purchased the stock on the terms above and immediately resold two thirds (a controlling interest) to Mr Temple and the Simms Manufacturing Corporation for $220,000 accepting notes of that amount in payment collateralized with the stock in question, plus the remainder of Mr Temple's holdings, and further secured by an insurance policy on his life amounting to $150,000 In return for this accommodation, the Simms Manufacturing Corporation had executed a contract to purchase and to use Midvale motors exclusively for a period of ten years The Simms Manufacturing Corporation had been a rather important customer for several years and, at the time this transaction was consummated, owed the Midvale Electric Company, Inc., $20,000, represented by notes Some repayments had been made on these various advances, the unpaid balance was represented by the 'Simms & Temple notes" of $120,000, maturing in the current year and classified

as current by the auditors, and \$87,500 under "Miscellaneous Notes Receivable." The \$100,810 of Simms Manufacturing Corporation notes receivable included in current assets were the result of additional working capital advances by Midvale Electric Company, Inc., \$40,000 in the form of shipments of motors on credit and \$60,810 in cash.

Mr. Vail was surprised to find that no recent statement of the Simms Manufacturing Corporation was available, and Mr. Burke admitted that while his concern had an actual liability of \$177,408 to the former Simms stockholders, repayment of the loans made to Mr. Temple and his company was dependent on the latter's future earnings, as its working capital position was not particularly strong.

Trade accounts receivable amounting to \$552,654 were "aged" in the audited report by date of billing as follows:

30 days or less	\$316,203
31 to 60 days	123,487
61 to 90 days	56,191
91 days and over	56,773
Total	\$552,654

According to Mr. Burke, bad debt losses had been nominal, and he defended the absence of a reserve for losses on accounts receivable on the ground that all accounts considered uncollectible had been charged off. He agreed, however, that conservative accounting procedure would demand a reserve for bad debts.

Current Liabilities.—After he had acquainted himself with the particulars of "Notes Payable—Individuals" of \$100,000, the item of \$77,408 representing "Notes—to Individuals" (due subsequent to one year), and the mortgage debt of \$567,484, the banker inquired briefly into the remaining items included in the current liabilities. While the bank indebtedness of \$190,000 had been in effect for almost a year, the usual practice of liquidating bank bank loans annually had been followed. In fact, this was the occasion for the request of a line of credit from the Third Bank and Trust Company. Trade notes payable of \$118,408 were explained as being due partly to the fact that buying on this basis from certain sources of supply enabled better adjustments on unsatisfactory merchandise or other claims (an explanation that Mr. Vail accepted with a grain of salt), and partly to inability to pay on regular terms. Miscellaneous accruals of \$50,450 and Federal income taxes of \$39,278 did not appear to be excessive. The investigation of the paying habits of the concern that would normally be related to consideration of the accounts payable had already been made.

The Decision

A revised analysis of the current statement to give effect to the reclassification of the receivables (see column A–Revised, Figure 73), indicated that the net working capital, instead of having increased, had declined from $463,538 to $282,210 during the year Moreover, the amount of the mortgage debt that would be due within one year should, strictly speaking, also have been included in the current liabilities, and this would have decreased the net working capital still further Cash and receivables actually current (sixty days or less), totaled $509,280, rather than $877,248, a sum less than the amount of the current liabilities

Mr Vail felt that the diversion of over $300,000 of working capital to the Simms Manufacturing Corporation situation was indefensible both because the inducement—a ten-year contract with a company with inadequate working capital and a problematic future—was inadequate, and because of its adverse effect upon the current position of the Midvale Electric Company, Inc Because of the unsatisfactory current ratio of 1.45, a total debt exceeding tangible net worth, heavy approaching maturities on account of the mortgage debt, and large bank borrowings at the season of the year when the corporation should normally have liquidated its bank debt, Mr Vail concluded that, in the event of unprofitable operations, a frozen situation was inevitable He also felt that Mr Burke's desire to increase volume, which had been responsible for the Simms Manufacturing Corporation transaction, would make it necessary for his banks to keep in close touch with his operations to prevent him from going off on a similar tangent later on The situation was not an attractive one

After reviewing these matters, Mr Vail suggested to Mr Burke that he concentrate his effort on recouping his working capital, and informed him that, until this had been acomplished, the Third Bank and Trust Company would be unable to entertain any request for a credit commitment

chapter XV

COLLATERAL BANK LOANS

THE PRACTICE OF MAKING LOANS ONLY AGAINST SECURITY HAS HAD a long and honorable history. Down through the ages, nobles and royalty often could obtain loans only upon excellent security, and even then they were at times charged excessive rates of interest. The Italian financiers, for example, exacted 120 per cent from such a questionable risk as Henry III of England and charged him 60 per cent more when he was not prompt in meeting his obligation. To protect themselves, these bankers took a lien upon the state income and then, to show their confidence in this extravagant, dissimulating monarch, set two merchants as guards to supervise his household accounts.

Typical Business Loans Are Unsecured

These illustrations are typical of concerns and institutions which borrow on a collateral basis. However, the majority of business enterprises that borrow probably do so on an unsecured basis, possibly with the endorsement or guaranty of the principals. Most business concerns do not have collateral that they can conveniently or readily pledge. Their funds are tied up in inventories which are moving in day-to-day operations and usually cannot be easily pledged for a commercial loan. Their funds are also tied up in current receivables representing recent sales.

Many business enterprises and individuals today borrow from banking institutions on a secured basis—that is, by pledging collateral. In these cases the collateral generally consists of stocks and bonds; merchandise covered by warehouse receipts, trust receipts, or bills of lading; discounted notes receivable and assigned accounts receivable; chattel mortgages; real estate; and cash surrender value of life insurance policies.

After a discussion of the various types of customer who borrow on a secured basis, this chapter will cover these classes of collateral with the exception of assigned accounts receivable The practice of borrowing on assigned accounts is treated in a separate chapter (XVII) because of the increased importance and the expanding volume of loans made in this manner during recent years

TYPES OF BORROWER ON SECURED BASIS

Commercial and Industrial Business Enterprises

The nature of some businesses is such that they are normally expected to furnish collateral when requesting loans A concern, for example, buys butter and eggs in the spring of the year and places them in a cold storage warehouse, anticipating their sale during the fall and winter The cold storage warehouse gives warehouse receipts to the butter and egg dealer for the merchandise that is stored The typical concern then borrows by pledging its warehouse receipts on a satisfactory margin at its bank for a loan

A particular concern may be entitled to receive an unsecured loan, based upon the record of the management and the showing of its comparative financial statements The banker may reasonably maintain, however that so long as the business holds warehouse receipts they should be pledged at the bank as reasonable additional security In addition, the banker may charge a slightly lower rate of interest on the loan if the warehouse receipts are pledged, because of this security

Certain business executives invest a portion of their surplus funds, either temporarily or permanently in securities, which they regard as a desirable secondary reserve for possible emergencies When short of funds, a business with such assets may prefer to continue to hold the securities and to pledge them for a loan rather than to sell them. The bank may not require the pledge of securities but the management of the business may wish to pledge them in order to obtain a slightly lower rate of interest

Stock Brokers and Investment Bankers

Stock brokers and investment bankers likewise generally furnish collateral when borrowing This collateral ordinarily consists of listed stocks and bonds with a sustained market and new issues of securities being underwritten and distributed The stock broker borrows in order to

lend money to his customers for the purchase of securities. When a customer buys securities on margin, the broker furnishes the additional funds to complete the payment. The stock broker who borrows in large amounts and lends in relatively small ones to a number of individuals obtains at times a somewhat better interest rate from the bank for his loans than does the individual borrower. Some brokers also act as dealers and purchase for their own account securities which they later resell. To carry these securities temporarily, they borrow, using them as collateral.

A common type of broker's loan is the demand or call loan, in connection with which the broker pledges listed securities. In 1929 the interest rate on these loans was as high as 20 per cent per annum; in 1946, by way of contrast, the average rate was down to 1.16 per cent per annum. Brokers also borrow on a time basis. Time loans are secured by collateral, run for a definite period at a definite rate of interest, and are not callable on demand.

Investment bankers, who underwrite issues of securities, also borrow for short periods to carry such securities during the process of distribution. As the securities pledged are sold, generally in a matter of a few days, the loan is ordinarily retired. When the commercial banker considers the request of the investment banker for a loan of this type, he must also make sure that the issuing corporation is in healthy financial shape and that the securities will normally find a ready market. He will likewise investigate the record and the financial standing of the investment banking house to be certain that in the event the securities do not sell, the loan nevertheless will be paid. Otherwise, a sudden drop in the security market might leave the bank with a frozen loan.

Institutions

There are also educational, charitable, and church organizations that receive the major portion of their income and contributions during a particular period of the year. In the event that these organizations have endowments consisting of securities, they may pledge the securities at a bank during the seasonal period of low income and borrow until the time when their income normally is larger. Educational institutions, operating on income from tuition, sometimes borrow on collateral in July and August to cover running expenses through the summer. These loans are then repaid in September and October, when tuitions and fees are received.

Commercial Banks

Commercial banks and trust companies also borrow occasionally fr other commercial banks, and member banks borrow from the Fede Reserve Banks, especially if they are temporarily in need of additio funds because of large local demands for loans. Such borrowing is complished by rediscounting paper the banks hold, by pledging c lateral, by obtaining Federal Reserve funds on an unsecured basis fr another bank, or by selling securities under a repurchase agreement. business enterprise may not be in a position to pledge its inventory, cause it is not easily available, but a bank always has bonds and notes t can be pledged easily.

Finance and Small Loan Companies[1]

For some years all of the larger companies as well as substantially the medium-sized companies in these fields have obtained their bank b rowings on a plain note basis, but some of the smaller finance compa continue to borrow on a collateral trust note basis or on the direct ple of their receivables. In some instances where a sizable company has lowed the practice of selling part of its receivables (on a non-recou basis), banks have asked the company to go on a collateral trust n basis, due particularly to implied warranties in the sales. Under a collat trust note arrangement, the finance company deposits receivables w the necessary margin with a trustee (usually a bank), subject to terms of an agreement under which the company issues its collat trust notes which are certified by the trustee. Where more than one b is involved in a credit, a collateral trust note basis is to be preferred t direct pledge, for if borrowings are spread among several banks, it assu each bank that there is no preference between them as to the quality paper pledged. The sales finance companies, handling a variety of ceivables evidenced by the notes of the purchasers of automobiles, ho hold equipment, and other hard goods, generally purchase this paper a discount basis. Hence, in accepting collateral either through a collat trust or on a direct pledge basis, it is desirable that a sufficient margi required so that the advance made by the bank does not exceed the investment of the finance company in the paper.

Further, it is good practice for the bank to require that the fin

[1] This section on finance and small loan companies was prepared by Ray H. Ma vice-president of The First National Bank of Chicago.

company "take out" at the first of the month all instalments of receivables maturing during that month and replace them with a new schedule of receivables. At the same time all paper having an instalment sixty days (or ninety days) delinquent should be withdrawn and replaced by current receivables. During recent years there has been a trend toward diversification in finance company operations, so that many companiés that formerly limited their activities to discounting retail instalment paper and making the related wholesale advances, now are actively engaged in the small loan or consumer finance business. In all loans where receivables are pledged as collateral to bank advances, it is of fundamental importance that the bank have complete dominion over its collateral. Although a trustee normally does not employ accountants to make periodic examinations, a bank holding a direct pledge, which is usually for a smaller company, is well advised to have an examination made several times a year to determine that the receivables pledged are being handled properly. If credits or adjustments are made to the amounts of the individual accounts, the approval of the bank should be obtained, or the receivables should be withdrawn and new receivables pledged.

Small loan companies generally collect interest monthly on their advances, this being a provision of the small loan acts of most states. In recent years precomputation of charges has been permitted in some states. Due to the fact that their borrowings have not been as high as discount companies in relation to their net worth, plus the legal as well as physical problems involved in handling the small average note, these companies have generally obtained their requirements on a plain note basis. The amount of their average note is considerably smaller than that of most discount companies, so that the work entailed in properly handling this type of collateral is comparatively expensive. The same general procedure should be followed as is set forth above for companies handling retail instalment paper.

Commercial finance companies rarely borrow on either a collateral trust or a direct pledge basis. Their receivables—particularly factored accounts or pledged accounts receivable—turn over so rapidly that a great amount of work would be involved in properly operating a pledge agreement.

Individuals

Although there are some exceptions to the rule, loans to individuals are usually secured. When a businessman presents the financial statement of

his business to obtain an unsecured loan, the banker examines with particular care the record of the business and its working capital position in order to determine the ability of the business to repay the loan. He considers especially such assets as accounts receivable and inventory An individual who borrows personally has no such current assets which may be liquidated to discharge his obligations He may possess marketable securities which he may pledge for a loan and which the banker may sell in the event of necessity to discharge the loan If the individual does not possess marketable collateral or chattels the banker must then look for payment solely out of the individual s income or out of the sale of possible fixed assets such as a home or a farm

However, the careful banker does not wish to be placed in a position where he must sell real estate to satisfy the personal loan Even where the real estate carries no mortgage, there is the necessity of obtaining legal possession of the property and of finding a satisfactory buyer, and such situations are more likely to come about in a depression than in a period of prosperity

Many bankers make small loans to individuals solely upon the good character of the borrower but guaranteed by one or two responsible friends of the borrower and repayable in monthly instalments Substantial loans however, to individuals on this basis are as a rule fundamentally unsound Prolonged sickness disability, or death might make a personal loan of this kind absolutely worthless Even when life insurance is carried as a protection for the banker the premiums on the insurance must be paid regularly When a business borrows on an unsecured basis, the banker looks to both the earning power and the assets for assurance that the loan will be repaid When an individual seeks to borrow on an unsecured basis serious consideration must be given to an unpredictable loss of his earning power Consequently, it is normally necessary to obtain a pledge of collateral for a loan to an individual In fact, if a prospective individual borrower possesses marketable collateral, there usually is no good reason why he should not pledge it to protect any loan he might obtain at his bank

A widely quoted maxim in the banking profession is that all loans above a nominal amount—for example $500—should be made on the basis of a financial statement or the pledge of collateral The exact amount whether $500 or some other nominal figure, would depend upon the size of the banking institution Chapter XVIII presents some exceptions to these general practices

STOCKS AND BONDS AS COLLATERAL[2]

Listed Securities

Stocks and bonds constitute the collateral most frequently used to secure bank loans. Such securities may be divided roughly into two groups: listed and unlisted. Simply stated, a listed security is any security that is bought and sold on one or more of the stock exchanges; whereas an unlisted security is not bought and sold on any stock exchange, but is dealt in privately between buyers and sellers. There are securities, however, that are dealt in on exchanges that have not formally been listed at the request of the issuing corporation. These are traded in on an exchange at the request of the exchange or of a member of it. These securities are sometimes referred to as unlisted, but for our purpose we shall consider any security bought and sold on an exchange as listed.[3]

Purchases and sales of securities on national securities exchanges[4] are limited to those issues that are registered with the exchange and with the Securities and Exchange Commission. This restriction does not apply to Federal government, state, and municipal securities which are legally exempt under the law. A corporation desiring to list its securities on the New York Stock Exchange must conform initially to the extensive listing requirements of the exchange, submitting, among other information, consolidated earnings' statements for the past ten years and balance sheets for two years with certificate or opinion of independent auditors. Detailed information must also be given on the history of the corporation, the business in which it is engaged, the properties owned or leased, affiliated companies, the management, capitalization, funded debt, stock provisions, labor and stockholder relations, dividend records, options, warrants, conversion rights, and any litigation.

[2] This statement on collateral loans was prepared by Robert B. Johnston, vice-president of The First National Bank of Chicago.

[3] An illustration of a proposed loan which was to be secured by unlisted stock as collateral will be found on page 351.

[4] A national securities exchange is any exchange registered with the Securities and Exchange Commission under the terms and conditions provided in Section 6 of the Securities Exchange Act of 1934. The following thirteen exchanges were registered as of December 31, 1959: American Stock Exchange, Boston Stock Exchange, Chicago Board of Trade, Cincinnati Stock Exchange, Detroit Stock Exchange, Midwest Stock Exchange, New York Stock Exchange, Pacific Coast Stock Exchange, Philadelphia-Baltimore Stock Exchange, Pittsburgh Stock Exchange, Salt Lake Stock Exchange, San Francisco Mining Exchange, and Spokane Stock Exchange. The following four exchanges are exempted as of December 31, 1959: Colorado Stock Exchange, Honolulu Stock Exchange, Richmond Stock Exchange, and Wheeling Stock Exchange.

Listing a security on an exchange adds marketability As a rule, a listed security is better collateral for a bank loan than one that is not listed. A security exchange provides a market where buyers and sellers of the particular listed stocks and bonds may deal in them The market for some securities on an exchange is more active than that for others The spread between the bid and asked prices of these active securities is less than that for inactive securities. Furthermore, there is a greater public interest in well-known securities, such as the common stocks of the United States Steel and General Motors corporations, than in less well known issues Therefore, larger blocks of securities in corporations widely known may be sold with little or no disturbance of the market. Naturally, active securities are most desirable for collateral purposes, since their values are more easily determinable

Sometimes, even when a stock is listed, there may be relatively little interest in it, and its market may be less active than for an unlisted stock of a well known corporation The spread between the bid and asked prices on some listed stocks, if they are inactive, may be five points or more. If the spread is consistently large and the market inactive, the banker should bear these facts in mind in connection with the possible sale of the collateral Under these circumstances he might find it difficult to liquidate the stock without a substantial reduction in price

The banker may quickly determine the market value of listed securities by the daily quotations in the leading newspapers On December 31, 1959, 1,507 stock issues aggregating 5,847,000 shares with a total market value of $307,708,000,000 were listed on the New York Stock Exchange[5]

Listing is more important to maintain a ready market for an issue of stocks than for an issue of bonds, since bonds are largely dealt in privately There were 1,180 issues of bonds listed on the New York Stock Exchange on December 31, 1959[6] Their par value as of December 31, 1959, was $120 508 000 000 and their total market value $105,422,000,000

The bonds that are dealt in on the two largest exchanges, the New York Stock Exchange and the American Stock Exchange, represent but a small fraction of the total bonds bought and sold in the financial district of New York City, whereas the stocks bought and sold on these two exchanges represent a substantial proportion of total stock transactions In fact, many of the listed bonds are continually being bought and sold over the counter, a less common process in the case of listed stocks

[5] From New York Stock Exchange *Fact Book 1960*
[6] *Ibid*

Unlisted Securities

There are many more issues of unlisted than listed securities, although the total value of the listed exceeds that of the unlisted. Among the unlisted securities are such issues as bank, trust company, and insurance company stocks; state and municipal issues; and the great majority of industrial stocks and bonds.

The market for unlisted securities is established by security dealers in so-called "over-the-counter" trading. Much of the business is conducted by telephone. Many dealers specialize in handling certain classes of securities, such as bank stocks, municipals, or insurance company stocks. As a result of the specialization of these dealers, many unlisted securities have a more active market than the listed securities of smaller, less well-known corporations.

There are also unlisted securities of small, local corporations which have practically no market. These issues ordinarily do not make satisfactory collateral for a loan. Sometimes the only interested purchasers of the collateral are the officers of the corporation, and in many such cases a substantial reduction in the price of the collateral must be granted to effect a sale.

Requirements for Making Loans Secured by Stocks and Bonds

There are five primary requirements to be considered in making loans secured by stocks and bonds: marketability, margin, length of the loan, purpose of the loan, and relationship to the income of the borrower.

Marketability.—The first requirement is that of marketability. A listed security generally tends to be more marketable. If possible, then, a banker should generally obtain as collateral not only listed securities but also those in which trading is active. Furthermore, whenever possible, the securities should represent well-established corporations, ably managed, and with a steady record of earnings. The information available in the services of Standard & Poor's Corporation, Inc., and Moody's Investors Service, Inc., described in Chapter V, is helpful in evaluating the desirability of both stocks and bonds as collateral.

Adequate Margin.—The second requirement is an adequate margin. Loans of this type are extended with the understanding that a stipulated margin of collateral value in excess of the loan will be maintained. While the existence of a safe margin of security and the marketability of the

collateral are paramount considerations, the fact that these requirements may be fulfilled does not relieve the loan officer of the necessity of establishing the ability of the borrower to furnish additional collateral to protect the loan in the event of a sustained decline in the market, and to repay it, preferably without resorting to the sale of the collateral The ability to liquidate the indebtedness out of income or from some other definite source is obviously particularly important if the collateral consists entirely or to a considerable extent of a stock that does not enjoy a listed or active unlisted market In such a case a market may be established by a pre-arranged agreement on the part of the corporation whose stock is pledged, or with an individual of means, such as an official of the issuing corporation, to purchase the collateral on demand at a stipulated price or to buy the borrower's note if the bank requests it

Length of Loan—The third requirement is concerned with the length of time the bank may be expected to carry the loan If the borrower wants the loan for much over a year, the banker may be somewhat hesitant to make it Sometimes collateral loans are made to individuals for a period longer than one year, but in such cases a definite program of gradual liquidation is arranged at the time the loan is granted Ordinarily, liquidation of a personal collateral loan is expected within a year The note will be made for ninety days, for example, and the loan will be renewed at the end of each ninety days up to a year, assuming that the collateral pledged and the margin continue satisfactory Partial payments may be made periodically so that the principal is gradually reduced

Purpose of Loan—The fourth consideration is the purpose for which the loan is made If the proceeds of the loan are to be used by the borrower to engage in some speculative venture or are to be lent by him to assist some other individual to pay an old debt, the banker may be reluctant to advance funds without pointing out to the borrower the responsibility he is undertaking

Relationship to Income—The fifth consideration, when a loan is being made to an individual against securities, is that the amount of the loan, as a rule, should bear a reasonable relationship to the borrower's income, entirely aside from the margin and marketability of the collateral A depression period emphasizes this requirement If a borrower with a $5,000 annual salary obtains a $25,000 loan against collateral of $50,000, the loan may appear to be perfectly safe At 6 per cent, the interest would amount to $1,500 annually The dividends from the collateral may easily pay the interest However, if there is a severe decline in business and the dividends are not paid, the borrower may be faced with an impossible finan-

cial load. He will have to meet not only the $1,500 annual interest charge but also some payment on the principal—all out of an income of $5,000 a year. If his own income declines, the situation may become essentially hopeless.

With a recession of business and the passing of dividends, the value of the stock may decline materially. The banker then will have an under-margined loan on which the borrower may not even be able to pay his interest. Hence a collateral loan is a better loan if it bears a normal relationship to the borrower's normal income. There is then a reasonable possibility of discharging the loan in the event of a business recession.

Margin Regulations

Bank loans made for the purpose of purchasing or carrying any stock registered on a national securities exchange are subject to regulations of the Board of Governors of the Federal Reserve System.[7] Any such loan must not exceed the maximum loan value of the collateral, which for stocks at the present time[8] is 30 per cent of the current market value of the stock pledged as collateral. The maximum loan value of the other collateral may be any value assigned in good faith by the bank. To illustrate, if a borrower wants to obtain a loan for the purpose of purchasing or carrying a listed stock, and pledges stock (listed and/or unlisted) whose current market value is $10,000, the maximum loan that may be made is $3,000.

Under the present regulations, if a borrower wants to obtain a loan for the purpose of purchasing or carrying a listed stock, and pledges both stocks (listed or unlisted), whose current market value is $10,000, and bonds, whose current market value is also $10,000, the maximum loan value of such stock is again $3,000. As indicated above, the banker may lend whatever he desires (in good faith) against the other collateral. If the bonds are very good, the banker may lend 90 per cent against them. Consequently, he may, in this illustration, lend $3,000 on the stock and $9,000 on the bonds, or a total of $12,000 on the $20,000 current market value of the collateral.

The following paragraphs from Regulation U, as amended to July 28, 1960, explain some of its principal provisions. Students of the subject of collateral loans should be thoroughly familiar with this Regulation and the Supplement.

[7] Regulation U of the Board of Governors of the Federal Reserve System, with the Supplement.

[8] July 28, 1960.

SECTION 221.1—GENERAL RULE

(a) No bank shall make any loan secured directly or indirectly by any stock for the purpose of purchasing or carrying any stock registered on a national securities exchange (and no bank shall make any loan described in Section 221.3 (q) regardless of whether or not such loan is secured by any stock) in an amount exceeding the maximum loan value of the collateral, as prescribed from time to time for stocks in Section 221.4 (the Supplement to Regulation U) and as determined by the bank in good faith for any collateral other than stocks.

(b) For the purpose of this part, the entire indebtedness of any borrower to any bank incurred at any time for the purpose of purchasing or carrying stocks registered on a national securities exchange shall be considered a single loan, and all the collateral securing such indebtedness shall be considered in determining whether or not the loan complies with this part.

(c) While a bank maintains any such loan, whenever made, the bank shall not at any time permit any withdrawal or substitution of collateral unless either (1) the loan would not exceed the maximum loan value of the collateral after such withdrawal or substitution, or (2) the loan is reduced by at least the amount by which the maximum loan value of any collateral deposited is less than the "retention requirement" of any collateral withdrawn. The "retention requirement" of nonstock collateral is the same as its maximum loan value, and the "retention requirement" of stock collateral is prescribed from time to time in Section 221.4 [the Supplement to Regulation U]. If the maximum loan value of the collateral securing the loan has become less than the amount of the loan, the amount of the loan may nevertheless be increased if there is provided additional collateral having maximum loan value at least equal to the amount of the increase.

SECTION 221.2—EXCEPTIONS TO GENERAL RULE

Notwithstanding the provisions of Section 221.1, a bank may make and may maintain any loan for the purpose specified in Section 221.1, without regard to the limitations prescribed therein, if the loan comes within any of the following descriptions:

(a) Any loan to a bank or to a foreign banking institution,

(b) Any loan made prior to July 16, 1945, to any person whose total indebtedness to the bank at the date of and including such loan does not exceed $1,000,

(c) Any loan to a dealer, or to two or more dealers, to aid in the financing of the distribution of securities to customers not through the medium of a national securities exchange,

(d) Any loan to a broker or dealer that is made in exceptional circumstances in good faith to meet his emergency needs,

(e) Any loan to a broker or dealer secured by any securities which, according to written notice received by the bank from the broker or dealer pursuant to a rule of the Securities and Exchange Commission concerning the hypothecation of customers' securities (Rule X-8C-1 or Rule X-15C2-1), are securities carried for the account of one or more customers provided the bank accepts in good faith from the broker or dealer a signed statement to the effect that he is subject to the provisions of Part 220 of this chapter (Regulation T) (or that he does

not extend or maintain credit to or for customers except in accordance therewith as if he were subject thereto);

(f) Any temporary advance to finance the purchase or sale of securities for prompt delivery which is to be repaid in the ordinary course of business upon completion of the transaction;

(g) Any loan against securities in transit, or surrendered for transfer, which is payable in the ordinary course of business upon arrival of the securities or upon completion of the transfer;

(h) Any loan which is to be repaid on the calendar day on which it is made;

(i) Any loan made outside the 50 States of the United States and the District of Columbia;

(j) Any loan to a member of a national securities exchange for the purpose of financing his or his customers' bona fide arbitrage transactions in securities;

(k) Any loan to a member of a national securities exchange for the purpose of financing such member's transactions as an odd-lot dealer in securities with respect to which he is registered on such national securities exchange as an odd-lot dealer.

SECTION 221.3–MISCELLANEOUS PROVISIONS

(a) In determining whether or not a loan is for the purpose specified in Section 221.1 or for any of the purposes specified in Section 221.2, a bank may rely upon a statement with respect thereto only if such statement (1) is signed by the borrower; (2) is accepted in good faith and signed by an officer of the bank as having been so accepted,[9] and (3) if it merely states what is not the purpose of the loan, is supported by a memorandum or notation of the lending officer describing the purpose of the loan. To accept the statement in good faith, the officer must be alert to the circumstances surrounding the loan and the borrower and must have no information which would put a prudent man upon inquiry and if investigated with reasonable diligence would lead to the discovery of the falsity of the statement.

(b) (1) No loan, however it may be secured, need be treated as a loan for the purpose of "carrying" a stock registered on a national securities exchange unless the loan is as described in section 221.3, (b) (2) or the purpose of the loan is to enable the borrower to reduce or retire indebtedness which was originally incurred to purchase such a stock, or, if he be a broker or a dealer, to carry such stocks for customers.

(c) In determining whether or not a security is a "stock registered on a national securities exchange" or a "redeemable security" described in paragraph (b) (2) of this section, a bank may rely upon any reasonably current record of such

[9] A statement similar to the following and addressed to the bank may be obtained by the banker: "I hereby certify that the purpose of the loan made by you to the the undersigned, evidenced by the undersigned's note for $______, dated ______ and payable to the order of your Bank, is *not* to purchase or carry stock registered on a National Securities Exchange within the meaning of Regulation U of the Board of Governors of the Federal Reserve System, or to reduce or retire indebtedness originally incurred to purchase such a stock. The purpose of the loan is ____________________ (signed by borrower) (At bottom of statement: The above statement is accepted in good faith ____(signature of lending officer)____."

securities that is published or specified in a publication of the Board of Governors of the Federal Reserve System

(d) Except as provided in paragraph (r) of this section the renewal or extension of maturity of a loan need not be treated as the making of a loan if the amount of the loan is not increased except by the addition of interest or service charges on the loan or of taxes on transactions in connection with the loan

(e) A bank may accept the transfer of a loan from another bank, or permit the transfer of a loan between borrowers without following the requirements of this part as to the making of a loan provided the loan is not increased and the collateral for the loan is not changed, and after such transfer, a bank may permit such withdrawals and substitutions of collateral as the bank might have permitted if it had been the original maker of the loan or had originally made the loan to the new borrower

(f) A loan need not be treated as collateralled by securities which are held by the bank only in the capacity of custodian depositary or trustee, or under similar circumstances if the bank in good faith has not relied upon such securities as collateral in the making or maintenance of the particular loan

(g) Nothing in this part shall be construed to prevent a bank from permitting withdrawals or substitutions of securities to enable a borrower to participate in a reorganization

(h) No mistake made in good faith in connection with the making or maintenance of a loan shall be deemed to be a violation of this part

(i) Nothing in this part shall be construed as preventing a bank from taking such action as it shall deem necessary in good faith for its own protection

(j) Every bank and every person engaged in the business of extending credit who in the ordinary course of business extends credit for the purpose of purchasing or carrying securities registered on a national securities exchange shall make such reports as the Board of Governors of the Federal Reserve System may require to enable it to perform the functions conferred upon it by the Securities Exchange Act of 1934 (48 Stat 881 15 USC Chapter 2B)

(k) Terms used in this part have the meanings assigned to them in a portion of section 3(a) of the Securities Exchange Act of 1934 (48 Stat 882, 15 USC 78c(a)) except that the term bank does not include a bank which is a member of a national securities exchange

(l) The term stock includes any security commonly known as a stock any voting trust certificate or other instrument representing such a security and any warrant or right to subscribe to or purchase such a security

(m) Indebtedness subject to Section 221 1 is indebtedness which is secured directly or indirectly by any stock (or made to a person described in paragraph (q) of this section), is for the purpose of purchasing or carrying any stock registered on a national securities exchange, and is not excepted by Section 221 2

(n) (1) The bank shall identify all the collateral used to meet the collateral requirements of Section 221 1 (entire indebtedness being considered a single loan and collateral being similarly considered as required by Section 221 1) and shall not cancel the identification of any portion thereof except in circumstances that would permit the withdrawal of that portion Such identification

may be made by any reasonable method, and in the case of indebtedness outstanding at the opening of business on June 15, 1959 need not be made until immediately before some change in that or other indebtedness of the borrower or in collateral therefor.

(2) Only the collateral required to be so identified shall have loan value for purposes of Section 221.1 or be subject to the restrictions therein specified with respect to withdrawals and substitutions; and

(3) For any indebtedness of the same borrower that is not subject to Section 221.1 (other than a loan described in Section 221.2 (d), (f), (g) or (h)), the bank shall in good faith require as much collateral not so identified as the bank would require (if any) if it held neither the indebtedness subject to Section 221.1 nor the identified collateral. This shall not be construed, however, to require the bank, after it has made any loan, to obtain any collateral therefor because of any deficiency in collateral already existing at the opening of business on June 15, 1959, or any decline in the value or quality of the collateral or in the credit rating of the borrower. It also does not require a bank to waive or forego any lien. In addition, it shall not apply to a loan to enable the borrower to meet emergency expenses not reasonably foreseeable, provided the loan is supported by a statement of the borrower describing the circumstances, accepted in good faith and signed by an officer of the bank as having been so accepted.

(o) In the case of a loan to a member of a national securities exchange who is registered and acts as a specialist in securities on the exchange for the purpose of financing such member's transactions as a specialist in such securities, the maximum loan value of any stock shall be as determined by the bank in good faith provided that the specialist's exchange, in addition to other requirements applicable to specialists, is designated by the Board of Governors of the Federal Reserve System as requiring reports suitable for supplying current information regarding specialists' use of credit pursuant to this section.

(p) A loan need not comply with the other requirements of this part if it is to enable the borrower to acquire a stock by exercising a right to acquire such stock which is evidenced by a warrant or certificate issued to stockholders and expiring within 90 days of issuance: PROVIDED, That (1) each such acquisition under this paragraph shall be treated separately, and the loan when made shall not exceed 75 per cent of the current market value of the stock so acquired as determined by any reasonable method, (2) while the borrower has any loan outstanding at the bank under this paragraph no withdrawal or substitution of stock used to make such loan shall be permissible, except that when the loan has become equal to or less than the maximum loan value of the stock as prescribed for Section 221.1 in Section 221.4 the stock and indebtedness may thereafter be treated as subject to Section 221.1 instead of this paragraph, and (3) no loan shall be made under this paragraph at any time when the borrower has any such loan at the bank which has been outstanding more than 9 months without becoming eligible to be treated as subject to Section 221.1. In order to facilitate the exercise of a right under this paragraph, a bank may permit the right to be withdrawn from a loan subject to Section 221.1 without regard to any other requirement of this part.

(q) Any loan to a person not subject to this part (Regulation U) or to Part 220 (Regulation T) engaged principally, or as one of the person's important activities, in the business of making loans for the purpose of purchasing or carrying stocks registered on a national securities exchange, is a loan for the purpose of purchasing or carrying stocks so registered unless the loan and its purposes are effectively and unmistakably separated and disassociated from any financing or refinancing, for the borrower or others, of any purchasing or carrying of stocks so registered Any loan to any such borrower, unless the loan is so separated and disassociated or is excepted by Section 221 2, is a loan "subject to Section 221 1" regardless of whether or not the loan is secured by any stock, and no bank shall make any such loan subject to Section 221 1 to any such borrower on or after June 15, 1959 without collateral or without the loan being secured as would be required by this Part 221 if it were secured by any stock Any such loan subject to Section 221 1 to any such borrower, whether or not made after June 15, 1959, shall be subject to the other provisions of this Part 221 applicable to loans subject to Section 221 1, including provisions regarding withdrawal and substitution of collateral

(r) If, on or after June 15, 1959, a loan is made for the purpose of purchasing or carrying a security other than a stock registered on a national securities exchange and the loan is secured by the security, but subsequently there is substituted as direct or indirect collateral for the loan a stock so registered which is acquired by the borrower through the conversion or exchange of the security pursuant to its terms, the loan shall thereupon be deemed to be for the purpose of purchasing or carrying a stock so registered In any such case, the amount of the outstanding loan, or such amount plus any increase therein to enable the borrower to acquire the stock so registered, shall not be permitted on the date such stock is substituted as collateral to exceed the maximum loan value of the collateral for the loan on such date, and thereafter such indebtedness shall be treated as subject to Section 221 1, provided, however, that any reduction in the loan or deposit of collateral required on that date to meet this requirement may be brought about within 30 days of such substitution [10]

Regulation U does not restrict the right of bankers to extend credit whether on securities or otherwise for any commercial, agricultural, or industrial purpose or any other purpose, except to purchase or to carry "stock registered on a national securities exchange" or a "redeemable security" For a "non-purpose" loan, the bank may lend on any collateral and use its own judgment as to the margin required

On the better-known, actively traded in listed stocks, banks generally require a margin of 20 to 30 per cent when the loan does not come under the regulation of the Board of Governors of the Federal Reserve System A bank may lend as high as 95 per cent on high-grade bonds, such as the

[10] Students of this subject will find it essential to have an understanding of Regulation T of the Board of Governors of the Federal Reserve System, which relates to the extension and maintenance of credit by brokers, dealers, and members of national securities exchanges

best municipal bonds, but as a general practice the loan value of most high-grade listed bonds is about 90 per cent of the market price. Loans against Government treasury notes and bonds may be made up to 95 per cent and in some cases to a slightly higher percentage of the market value.

Margin requirements vary in different sections of the country, at different times, and for different types of borrowers. If the prices of securities have experienced a marked advance, the banker may increase his margin requirements and may establish arbitrary loan values for stocks that to him seem overpriced. If the borrower has additional collateral which he can pledge in the event of a severe market decline, the banker may lend somewhat more than he would if the borrower had no additional means to protect his loan. In case the pledged securities are those of a small local enterprise, the banker may require more than the customary margin, because of the limited marketability of the collateral. Each unlisted security is considered on its own merits, and such factors as the ability of the management, the financial condition of the corporation, and the record of earnings are carefully weighed.

Practical Procedure in Making the Loan

As a necessary first step toward making a loan secured by stocks or bonds, the banker must be certain that the securities offered are assignable. To illustrate, United States Savings Bonds[11] may not be transferred or assigned by the persons to whom they are issued. The banker must also determine whether the borrower owns the collateral and has the right to pledge it. A stock certificate may be in "street name"—that is, in the name of a broker through whom the stock was purchased or of some other broker. The certificate should be endorsed in blank on the reverse side, and the signatures of the endorsers guaranteed by a bank or stock exchange member. As a rule, the banker will ask that stock in street name be placed in the name of the borrower, unless the borrower is a broker or a dealer in securities. In the latter case, for convenience and facility in handling, the stock certificates may be left in the street name.

A bond may be made out to the bearer or may be registered. No special procedure is required with bearer bonds, other than to be certain that the bearer is the legal owner. This fact is ordinarily established by the word of the bearer and the fact that he is known to the banker through his relationship as a depositor of the bank.

[11] Series E, F, G, H, and K.

When stocks and registered bonds are presented as collateral, a stock power or a bond power must be obtained for each stock certificate or each bond assigned by the individual in whose name the stock or bond stands. Such powers are actually powers of attorney, which authorize the bank to transfer the securities should some situation arise making this desirable or necessary. By obtaining powers, the bank does not need to have the stock certificates endorsed or the registered bonds transferred to bearer (Figures 77 and 78).

Figure 77 Stock Power Signed by Owner and Given to Bank

For Value Received I (WE) HEREBY SELL, ASSIGN AND TRANSFER UNTO

____

____

____

____

________________ (______) Shares of the ____________

Capital Stock of the ________________________

standing in ________________ name(s) on the books of said ____________

________________ represented by Certificate No. ____________ herewith

and do hereby irrevocably constitute and appoint ________________

________________ attorney to transfer the said stock on the books of the within named Company with full power of substitution in the premises.

Dated ____________

In Presence of

____

____

There are occasions when a borrower presents collateral belonging to some other individual. In such a case the legal owner of the security executes a form known as a "consent to pledge" (Figure 79). After this form is executed, the borrower has essentially the same rights and powers in relation to the pledging of the security as the legal owner. Stock powers and bond powers may also be required in connection with such loans.

Any corporation that borrows, on either a secured or an unsecured basis, must present a resolution (Figures 80A and 80B) of its board of directors indicating which officers have been authorized to borrow for the

corporation and to pledge its assets if the loans are secured. Loans to executors, trustees, guardians, and receivers are made only after the banker has been given evidence of the legal authority of the borrower to act in that respect and to pledge collateral if the loans are to be secured.

Figure 78 Bond Power Signed by Owner and Given to Bank

FTM

For Value Received, I, (WE) HEREBY SELL, ASSIGN AND TRANSFER UNTO

____

____

____

________ Bonds of $1,000 each, Nos.________

________ Bonds of $____ each, Nos.________

________ Bonds of $____ each, Nos.________

of the________________________

________________now registered in________________name(s)

on the books of the________________________

and do hereby irrevocably constitute and appoint ________________

________________________ attorney to transfer the said bonds on the books of the Registrar with full power of substitution in the premises and for that purpose said attorney is hereby fully empowered to make and execute all necessary acts of assignment and transfer.

Dated________________

IN PRESENCE OF

________________ ________________

Typical Requests for Loans on Securities

An examination of three typical requests for collateral loans may be helpful in analyzing the practical aspects of such loans.

Illustration 1.—John A. Drake, a depositor of the Third National Bank of New Orleans, called on Mr. Taylor, vice-president, and requested a loan of $10,000 to meet his income tax payment, a mortgage prepayment, and certain other personal expenses. He offered as collateral diversified stocks, all actively traded on the New York Stock Exchange, and informed Mr. Taylor that he would expect to reduce the loan out of income at the end of ninety days and liquidate it in full possibly in six and surely in nine months. Mr. Taylor was aware that Mr. Drake drew a salary in the neighborhood of $30,000 annually from the corporation of which he was treasurer. Mr. Drake also informed him that he owned listed securities with a current market value of around $50,000, with which he

could protect the loan in the event of a decline in the market His personal checking account averaged in the neighborhood of $3 000

The proposed loan obviously met all of the requirements as to adequacy and marketability of collateral and as to ability to liquidate within a reasonable period without resorting to the sale of the collateral In ad-

Figure 79 Consent-to-Pledge Form Executed by Owner of Securities

CHICAGO, ILL.________________19____

THE FIRST NATIONAL BANK OF CHICAGO
CHICAGO ILLINOIS

Gentlemen

In consideration of your making, renewing or extending a loan or loans to________________________________

____

____

hereinafter referred to as the "borrower" for which the following property belonging to me has been tendered to you as collateral security to-wit

____

____

____

____

____

and for the purpose of enabling said borrower to obtain credit therefore, I hereby certify that the said property has been duly assigned, [illegible], transferred and delivered by me to said borrower and by these presents, I do hereby assign, [illegible] and transfer unto said borrower all of my right, title and interest in and to said property and hereby expressly authorize said borrower to pledge or hypothecate, all or any part of said property for the indebtedness aforesaid, and all renewals and extensions thereof, and also for any and all other indebtedness of the same borrower to you, whether alone or with others, direct or indirect, absolute or contingent and howsoever acquired by you, created at any time before this authorization shall have been revoked in writing received by you and all renewals and extensions thereof and I waive notice of all or any such indebtedness or extension, or renewal thereof.

Furthermore, I request, that you give, or continue to give said borrower, credit in the form of loans or renewals, or extensions as aforesaid, and in consideration of all or any such credit so granted by you, I agree that all or any property pledged or hypothecated as aforesaid, shall be subject in your hands or those of your assignees, or pledgee or pledgees, to all powers which would apply thereto by contract or otherwise if said property in fact so pledged or hypothecated stood in the name of said borrower himself and not in my name. The proceeds of all loans shall be accounted for and paid over to the borrower aforesaid, and said collateral securities may be disposed of and/or paid over to or upon the direction of said borrower

This agreement shall be binding on my heirs, executors, administrators and assigns and inure to the benefit of your successors and/or assigns.

________________________(SEAL)

WITNESS ________________________(SEAL)

____

dition, the borrower carried a satisfactory balance Mr Taylor, therefore, readily acceded to Mr Drake s request and discounted his ninety-day collateral note (Figure 81) secured by stocks with a market value of $16 000, with an understanding that, if the market value of the collateral should fall below 120 per cent of the amount of the loan, additional securities would be deposited or the loan would be sufficiently reduced to cover the deficiency

For those who would like to examine additional forms of secured

notes, Figure 82 shows a form of time or demand secured note and Figure 83 is an example of a time secured note used when a bank lends to a broker on customers' securities.

Figure 80A Resolution of Board of Directors Authorizing Certain Officials to Sign Checks, Drafts, and Orders in behalf of the Corporation and to Pledge Collateral (*front*)

I, the undersigned, *Do Hereby Certify*, that the following is a complete, true and correct copy of certain resolutions of the Board of Directors of____________________,
(Name of corporation in full)
a corporation duly organized and existing under the laws of the State of____________,
(Name of State where organized)
which resolutions were duly adopted at a duly called meeting of the said Board, held on________,
(Date of meeting)
19____, a quorum being present, and are set forth in the minutes of the said meeting; that I am the keeper of the corporate seal and of the minutes and records of this Corporation; and that the said resolutions have not been rescinded or modified:

Authorized signatures for indorsement

Be It Resolved, that THE FIRST NATIONAL BANK OF CHICAGO (hereinafter sometimes referred to as the "Bank") be and hereby is designated a depositary in which the funds of this Corporation may be deposited by its officers, agents, and employes, and that such officers, agents, and employes shall be and each of them hereby is authorized to indorse for deposit or negotiation any and all checks, drafts, notes, bills of exchange, and orders for the payment of money, either belonging to or coming into possession of this Corporation. Indorsements for deposit may be by the written or stamped indorsement of this Corporation without designation of the person making the indorsement;

Authorized signatures on checks

Be It Further Resolved, that the______________________________

____

____

____

(Titles of officers and/or other persons authorized to sign checks; e. g.: President, Treasurer, etc.; also, please indicate in what *manner the above-named officers are to sign—singly, any two, or jointly, etc.*)

of this Corporation (are) (is) authorized to SIGN ANY AND ALL CHECKS, DRAFTS, AND ORDERS, including orders or directions in informal or letter form, against any funds or accounts at any time standing to the credit of this Corporation with the Bank, and that the Bank hereby is authorized to honor any and all checks, drafts and orders so signed, including those drawn to the individual order of any such officer or other person signing the same, without further inquiry or regard to the authority of said officer or other person or the use of the checks, drafts and orders, or the proceeds thereof;

Authorized signatures on notes and obligations, etc.

Be It Further Resolved, that the______________________________

____

____

____

(Please indicate in what manner the above named officers are to sign—singly, any two, or jointly, etc.)

Illustration 2.—The second illustration indicates some of the factors which must be considered in a request for a loan on non-marketable collateral. Franklin R. French, treasurer of the Reliance Tool Company,

Inc., requested a loan of \$10,000 from the Fourth National Bank of Cleveland. He desired these funds to purchase enough additional stock in his corporation to bring his holdings to one third of the total outstanding stock. Mr. French owned \$15,000 out of \$75,000 par value of

Figure 60B Resolution of Board of Directors (*reverse*)

of this Corporation (are) (is) authorized to borrow from time to time on behalf of this Corporation from the Bank such sums of money for such times and upon such terms as may to them, or any of them, seem advisable, and to execute in the name of the Corporation notes, drafts, or agreements for the repayment of any sums so borrowed, and they and each of them are hereby authorized to discount with the said Bank any of the notes, bills receivable or acceptances held by this Corporation upon such terms as may to them, or any of them, seem advisable, and they and each of them are hereby severally authorized to mortgage, pledge, and assign as security to the Bank any and all of the real, personal and mixed property and assets of this Corporation, including without in any manner limiting the foregoing, the pledge of notes, bonds, stocks, bills receivable, warehouse receipts and other documents, accounts and securities of this Corporation, and to execute and deliver any and all documents of mortgage, pledge, assignment or transfer or indorsements of any thereof which may be necessary or proper effectually to mortgage, pledge, and assign such property and assets to the Bank.

Be It Further Resolved, that each of the foregoing resolutions shall continue in force until express written notice of its rescission or modification has been received by the Bank, but if the authority contained in them should be revoked or terminated by operation of law without such notice, it is resolved and hereby agreed for the purpose of inducing the Bank to act thereunder, that the Bank shall be saved harmless from any loss suffered or liability incurred by it in so acting after such revocation or termination without such notice.

I further Certify that the following named persons are the officers of the said Corporation, duly qualified and now acting as such:

President__________	Asst. Secretary__________
Vice President__________	Asst. Treasurer__________
Vice President__________	__________
Secretary__________	__________
Treasurer__________	__________

In Witness Whereof I have hereunto subscribed my name and affixed the seal of the said Corporation this_____day of_______________, A. D. 19____.

____
Secretary

SEAL

IMPORTANT

Imprint Seal of Corporation Here

the stock outstanding, while his two associates in the business each owned \$30,000. They were each willing to sell him \$5,000 par value of stock at par, in order to equalize the equity ownership. Having no marketable securities, he proposed to pledge his entire stock holdings in the corpora-

tion as collateral to the loan, which he then expected to repay in about two years, partly out of his salary and partly from dividends.

Mr. Vance, the loan officer to whom the request was made, was disposed to accommodate Mr. French if possible, since the corporation carried

Figure 81 Form of Collateral Note

COLLATERAL NOTE

$\$$__________ ________________, 19____

On __________ (Insert "demand" or a date) ____, the Undersigned (said term as used herein meaning the party or parties by whom or on whose behalf this note is signed, and who, if more than one, shall be jointly and severally liable hereunder) promises to pay to the order of **THE PHILADELPHIA NATIONAL BANK** (hereinafter called the "Bank") at any of its banking offices ____________________ Dollars, together with interest thereon from the date hereof at the rate of_____% per annum, without defalcation, for value received.

The term "Collateral" as used herein means the following property which has been or is hereby delivered, assigned, or hypothecated to the Bank ____________________

and any other property of any nature whatsoever of the Undersigned or any of them, now or hereafter in the possession of or assigned or hypothecated to the Bank for any purpose, including all dividends and other rights in connection with any shares of capital stock included in said property The Undersigned agrees that the Bank shall have a lien upon and security interest in the Collateral to secure the payment of this note and any renewals, extensions and modifications thereof and all other existing and future obligations of the Undersigned, or any of them, to the Bank of any nature whatsoever and out of wherever transactions arising, said note and any renewals, extensions and modifications thereof and said other obligations being hereinafter collectively referred to as the "Liabilities" If any other Liabilities are in existence when this note is paid, then, notwithstanding the surrender of this note, the Bank may retain the Collateral and shall have with respect thereto all rights and remedies available to it, including those herein granted or referred to As additional security for the payment of the Liabilities, the Bank is hereby given a lien upon and a security interest in any amounts which may be owing from time to time by the Bank to the Undersigned or any of them said amounts including any balance or share belonging to the Undersigned or any of them, of any deposit or other accounts with the Bank, which lien and security interest shall be independent of any right of set-off which the Bank may have The Undersigned assumes full responsibility for preservation of the Collateral, including taking any steps necessary to preserve any rights of the Undersigned, or any of them, or the Bank in it against prior parties. The Bank shall be deemed to have exercised reasonable care of the Collateral if it takes such action for that purpose as the Undersigned shall reasonably request in writing but no failure to comply with any such request shall of itself be deemed a failure to exercise reasonable care and no failure to do any act not so requested shall be deemed a failure to exercise reasonable care If any property included in the Collateral shall at any time become unsatisfactory to the Bank, the Undersigned shall within two hours after demand and as the Bank may direct deliver, assign or hypothecate to the Bank as part of the Collateral additional property which is satisfactory to the Bank.

In addition to all other rights possessed by it, the Bank shall have the following rights each of which may be exercised at any time: (i) to pledge or transfer this note and any renewals, extensions and modifications thereof, assigning therewith the Bank's rights in the Collateral or any portion thereof, and any such pledgee or transferee shall have all the rights of the Bank hereunder with respect to this note and any renewals extensions and modifications thereof and any of the Collateral so assigned therewith, and the Bank shall be thereafter relieved from all liability with respect to any of the Collateral so assigned (ii) to transfer the whole or any part of the Collateral into the name of itself or its nominee, (iii) to vote the Collateral, (iv) to notify the persons obligated on any of the Collateral to make payment to the Bank of any amounts due or to become due thereon, and (v) to take control of any proceeds of the Collateral.

The Undersigned shall be in default hereunder upon the occurrence of any of the following events (a) the nonpayment when due of any amount payable on any of the Liabilities, or the failure to perform any agreement of the Undersigned herein contained (b) if any Obligor becomes insolvent or makes an assignment for the benefit of creditors or if any petition is filed by or against any Obligor under any provision of any law or statute alleging that such Obligor is insolvent or unable to pay debts as they mature (the term "Obligor" as used herein being meant to include the Undersigned, and if more than one each of them and all parties secondarily liable on this note or on any renewal, extension or modification thereof, such as endorsers or guarantors), (c) the entry of any judgment against any Obligor or the issuing of any attachment or garnishment against any property of any Obligor or the occurrence of any adverse change in the financial condition of any Obligor, (d) the dissolution, merger, consolidation or reorganization of any Obligor which is a corporation or partnership, and (e) the death of any Obligor who is a natural person. Whenever the Undersigned shall be in default as aforesaid, (1) unless the Bank elects otherwise the entire unpaid amount of such of the Liabilities as are not then due and payable shall become immediately due and payable without notice to or demand on any Obligor, and (2) the Bank may at its option exercise from time to time any or all rights and remedies available to it under the Uniform Commercial Code as in effect from time to time in Pennsylvania or otherwise available to it including the right to dispose of the Collateral at public or private sale(s) or other proceedings, and the Undersigned agrees that the Bank or its nominee may become the purchaser at any such sale(s) and that the portion of the proceeds of any such disposition which is applicable to the Liabilities may be applied to or on account of the payment of such of the Liabilities and in such order as the Bank may elect. Any failure of the Bank to exercise any right hereunder shall not be construed as a waiver of the right to exercise the same or any other right at any other time The Undersigned waives all right to stay of execution and exemption of property in any action to enforce any of the Liabilities The additional provisions, if any on the reverse side hereof are hereby made a part hereof The Undersigned intends this to be a sealed instrument and to be legally bound hereby All issues arising hereunder shall be governed by the law of Pennsylvania.

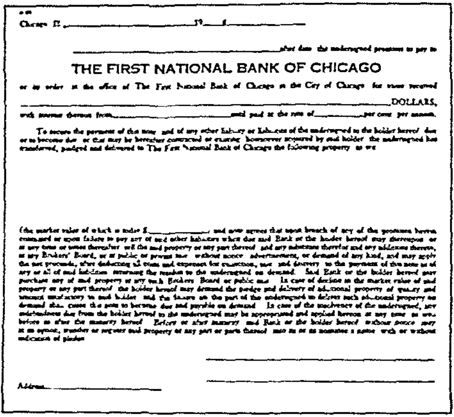
(INDIVIDUALS SIGN BELOW)		(CORPORATIONS OR PARTNERSHIPS SIGN BELOW)	
Name	(SEAL)	Name of Corporation or Partnership	(SEAL)
Name	(SEAL)	By Name and Title	
Name	(SEAL)	Name and Title	

Form 1813

a satisfactory deposit account, averaging in the neighborhood of $20,000. He ascertained that Mr. French could reduce the loan $2,000 a year out of his salary. The payment of dividends, however, appeared problematical. Losses for the three prior years had wiped out the surplus account of the corporation, and the previous year had closed with a $5,000 surplus

deficit. Earnings of $10,000 for the current year now closing would, however, convert this deficit into a surplus of about $5,000. The working capital position, with current assets of $52,687 to pay current liabilities of $7,625, was excellent, and the corporation had not borrowed for years. Mr. French admitted that the payment of dividends was dependent entirely upon earnings, but in his opinion the outlook for sales and profits in the coming year was promising.

Figure 82: Form of a Time or Demand Secured Note


Chicago, Ill., ______ 19__ $______

______ after date the undersigned promises to pay to

THE FIRST NATIONAL BANK OF CHICAGO

or its order at the office of The First National Bank of Chicago in the City of Chicago for value received

______ DOLLARS,

with interest thereon from ______ until paid at the rate of ______ per cent per annum.

To secure the payment of this note and of any other liability or liabilities of the undersigned to the holder hereof, due or to become due, or that may be hereafter contracted or existing, howsoever acquired by said holder, the undersigned has transferred, pledged and delivered to The First National Bank of Chicago the following property, to wit:

(the market value of which is now $______) and now agrees that upon breach of any of the promises herein contained [illegible]

______

______

Address ______

Mr. Vance carefully reviewed the entire situation. Since the collateral offered was not marketable and the prospect of repayment within two years was too uncertain, he declined to lend Mr. French $10,000. However, he did tell Mr. French that he would lend him $4,000 to buy that amount of stock because it appeared that Mr. French could repay $2,000 annually out of his salary alone.

Illustration 3.—This example has factors that might make even a safe

loan one which a banker would hesitate to make. John R. Moffitt, who had carried a small personal checking account with the Valley Bank & Trust Company of Denver for several years, applied for a loan of $800, offering as collateral a $1,000 listed bond with a market value of $990. After some conversation Mr. Smith, the loaning officer upon whom he called, learned that Mr. Moffitt had been unemployed for several months

Figure 83 Form of a Time Secured Note Used when a Bank Lends to a Broker on Customers' Securities

D20 B

NOTE FOR LOANS AGAINST CUSTOMERS' SECURITIES

CHICAGO, ILL.________________19____ $__________

________________*after date, the undersigned promises to pay to*

THE FIRST NATIONAL BANK OF CHICAGO

or its order, at the office of The First National Bank of Chicago in the City of Chicago, for value received

________________________*DOLLARS,*

*with interest thereon from*____________*until paid at the rate of*________*per cent per annum*

To secure the payment of this note, and of any other liability or liabilities of the undersigned to the holder hereof, arising out of or in connection with loans made against Customers' Securities due or to become due, or that may be hereafter contracted or existing, howsoever acquired by said holder, the undersigned has transferred, pledged and delivered to The First National Bank of Chicago the following property, to wit

SUNDRY SECURITIES LISTED ON SCHEDULES OF COLLATERAL, HERETOFORE, NOW OR HEREAFTER DELIVERED TO THE HOLDER HEREOF

*(the market value of which is today $*__________*) and now agrees that upon breach of any of the promises herein contained or upon failure to pay any liabilities of whatever type of the undersigned to the holder hereof when due, said Bank or the holder hereof may thereupon, or at any time or times thereafter, sell the said property or any part thereof, and any substitute therefor and any additions thereto, at any Brokers' Board, or at public or private sale, without notice, advertisement, or demand of any kind, and may apply the net proceeds, after deducting all costs and expenses for collection, sale, and delivery, to the payment of this note or of any or all of said liabilities, returning the residue to the undersigned or to such parties who shall be entitled thereto on demand Said Bank or the holder hereof may purchase any of said property at any such Brokers' Board or public sale In case of decline in the market value of said property or any part thereof, the holder hereof may demand the pledge and delivery of additional property of quality and amount satisfactory to said holder, and the failure on the part of the undersigned to deliver such additional property on demand shall cause this note to become due and payable on demand In case of the insolvency of the undersigned, any indebtedness due from the holder hereof to the undersigned may be appropriated and applied hereon at any time, as well before as after the maturity hereof Before or after maturity, said Bank or the holder hereof, without notice, may at its option, transfer or register said property or any part or parts thereof, into its or its nominee's name, with or without indication of pledge*

____

____

*Address*________________

and, having exhausted his cash resources, desired to borrow to take care of living expenses. There appeared to be no prospect for immediate employment, and Mr. Moffitt had no other assets.

Mr. Moffitt was notified that if he insisted, the loan would be granted in consideration of the fact that his relations with the bank extended over a period of years. The banker advised against the loan, however, as in all probability Moffitt would be unable to liquidate it, and the bank did not want to be placed in the position of having to sell the collateral. Mr.

Smith also pointed out that, in the absence of other collateral, the loan would be unprotected if the bond declined in market value These considerations, which had not occurred to Mr Moffitt, dissuaded him from persisting in his request for a loan, and he decided to obtain the needed funds by selling the bond

After Secured Loans Are Made

After loans on securities are made, the value of the collateral must be checked regularly This affords protection to both the bank and the customer If the current market value of the collateral falls and the loan becomes undermargined, the borrower is customarily required to pledge additional collateral or to make a reduction in the loan In the event that the impairment of the margin is substantial and the borrower is unable to furnish additional collateral or to reduce the loan, the bank may need to sell the collateral in order to avoid a loss Ordinarily a banker is reluctant to sell collateral, unless the bank cannot be protected in any other way If the collateral should consist of a large block of a relatively inactive stock, liquidation of the entire block at one time might be inadvisable, because the market price might be seriously depressed, and both the bank and borrower would lose thereby A program of gradual liquidation in that case would be a better policy In general, a seasoned banker seeks diversification in collateral rather than too large blocks of single issues

In large banks particularly where there are a great many loans secured by stocks and bonds a control record is kept to show the total amount of any given security pledged for various loans Stock of a certain corporation may have been pledged by a dozen different borrowers A severe decline in the market value of this stock might affect a number of loans adversely If the stock is relatively inactive, the banker should obviously accept no more of the stock as collateral than could readily be liquidated Loans to brokers and dealers in particular should be watched in this respect Loans to individuals, especially to executives who pledge their corporation's securities, should also be considered from this standpoint As a general rule a banker does not want to have as collateral so much of one security issue that the bank is in the position of 'owning the corporation because of the loans made on its stock

After loans are on the books, substitutions in the collateral held by the bank are frequently necessary Brokers and dealers must make substitutions because of the transactions of their customers Individual bor

rowers likewise often sell securities and buy other issues. The banker must satisfy himself that substitutions of collateral do not lessen the security originally taken for a loan. This watchfulness is particularly necessary in active brokers' accounts, where many changes may be made in the collateral. If care is not exercised, the collateral may be progressively weakened over a period of time.

When borrowers are permitted to remove a pledged security for the purpose of making substitutions or for other proper purposes, they sign a form of trust receipt (Figure 84). When the security is returned, or cash

Figure 84 Trust Receipt Signed by Borrower when Withdrawing Collateral

Received, In Trust from THE FIRST NATIONAL BANK OF CHICAGO, ILLINOIS

____

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and the undersigned hereby undertakes to hold the said property on account of said Bank and subject to its order for the purpose of being sold, or otherwise dealt with, as the said Bank may direct, and when sold, to pay in the net proceeds to said Bank. The undersigned expressly agrees that there is hereby created a trust of the property described for said Bank and that the Bank may at any time take possession of said property wherever located The undersigned further agrees that the security interest (as defined in the Uniform Trust Receipts Act of the State of Illinois) in the goods, documents and instruments described herein, remains in the said Bank for itself or for any one for whom it is acting as agent.

____

Chicago, ________________ 19____

is paid in place of the security, or some other security is substituted, the bank returns the trust receipt. Ordinarily securities taken out on trust receipts should not remain outside the bank longer than the time necessary to make a substitution of securities or complete whatever legitimate objective the customer had in mind when he signed the trust receipt and withdrew the securities. Otherwise, if the borrower were dishonest, he might withdraw collateral by signing a trust receipt and then pledge the collateral elsewhere for another loan.

There is a pledge agreement (Figure 85) which the borrower may sign if the collateral he is to pledge is not promptly available for his loan. The

securities may, for example, be in another city. If the banker is satisfied through his knowledge of the borrower and the facts in the case, he may accept this pledge agreement which provides that the collateral will be delivered at a later date. This form of pledge agreement has been developed as the result of the Uniform Trust Receipts Act, which is now a law in a number of states.

Figure 85 Agreement to Pledge Used When Collateral Is Not Available at the Time of Making a Loan

AGREEMENT TO PLEDGE
AS PROVIDED FOR BY THE UNIFORM TRUST RECEIPTS ACT
OF THE STATE OF ILLINOIS

For new advances this day received, the undersigned hereby agrees to pledge with The First National Bank of Chicago as collateral security for the payment of said new advances and any and all other indebtedness of the undersigned, now or hereafter due and owing to said bank or its successors or assigns, the following property, to-wit:

____

____

____

____

____

The undersigned further agrees to deliver said property to said bank, or its order, immediately upon the request of said bank (whether written or oral), but in any event, on or before ten (10) days from date hereof.

The undersigned further agrees that this agreement shall be binding upon the heirs, executors, administrators, successors or assigns of the undersigned and inure to the benefit of the successors or assigns of said bank.

The undersigned further agrees that all rights, interests, duties and liabilities arising hereunder shall be determined according to the laws of the State of Illinois.

The undersigned hereby acknowledges receipt of a copy of this agreement.

____

By ______________________________

Dated at Chicago, ______________________ 19___

MERCHANDISE LOANS[12]

Loans on Commodities

Many banks make loans secured by marketable commodities that are stored in warehouses or are in transit. The goods that serve as collateral should be readily marketable, non perishable staples, and properly insured. The Board of Governors of the Federal Reserve System defines the term "readily marketable staple" to mean "an article of commerce, agriculture, or industry, of such uses as to make it the subject of constant dealings in ready markets with such frequent quotations of price as

[12] This statement on merchandise loans was prepared by James P. Baxter, vice president of The First National Bank of Chicago.

to make (a) the price easily and definitely ascertainable, and (b) the staple itself easy to realize upon by sale at any time."[13]

The commodities against which loans are generally made cover an extremely wide range, including cotton, grain, wool, raw silk, leather, hides, tobacco, furs, potatoes, olive oil, coffee, tea, spices, butter, meat, eggs, cheese, frozen foods, poultry, rubber, sugar, rice, alcohol, nuts, and naval stores. Commercial banking institutions located in communities that specialize in producing commodities such as cotton or grain may be familiar with loans on these products but unfamiliar with those secured by other products. In order to lend intelligently on these various commodities, the banker must study carefully such factors as the current market for the commodity,[14] the quality of the product,[15] general price movements, and the extent of a possible carry-over of unsold inventory from the previous season. The extent of the carry-over of cotton, for example, from one season to another may have a significant bearing upon the trend of cotton prices. Additional factors to be considered are Federal price support programs for various agricultural commodities. No less important, however, than the commodity itself are the reputation and the responsibility of the warehouse in which the goods are stored.

[13] Regulation C, revised, effective August 31, 1946, p. 3.

[14] Joseph F. Meyer, Jr., vice-chairman of the Houston National Bank, Houston, Texas, explains the practical need for such knowledge. "We know that there is very little market for canned oysters on the Gulf Coast because people eat fresh oysters nine months a year and don't buy many canned oysters during the off season. So we limit our loans on canned oysters. On the other hand, we ran into a different situation with the local fig industry. Figs are a delicacy on anybody's table, but they deteriorate so rapidly that it is almost impossible to get them to market beyond local points. Local consumption was not sufficient. When we saw that farmers were getting nowhere, we ourselves studied the situation and worked out a solution. Then we approached the proper people, showed them where they could pay fig raisers a better price, take their entire crops, can and preserve figs, market them in an orderly manner, and convert a losing industry into a profitable one. Today, as a result, South Texas preserved figs are in demand, even in foreign countries." From an article, "Loans on Commodities," *The Burroughs Clearing House* (August 1937).

[15] To illustrate the necessity for considering the quality or grade of a product, G. C. Dreher, a former vice-president of the First Wisconsin National Bank of Milwaukee, Wis., has pointed out that ". . . some commodities become more valuable with age, while others deteriorate, and still others go in one direction for a period and then go in the other. An example of the latter is Swiss cheese. . . . Newly made Swiss has a given value. Aging it improves it, up to a very definite limit. Swiss cheese of the right age is worth several times as much as green Swiss. But a month later it is worth about 10 per cent of the maximum, since beyond the maximum age it collapses, its holes close, and it is usable only when melted and packaged. At the other extreme, Wisconsin tobacco becomes better for several years in storage, and in a stable market increases in value every few months." From an article, "What to Watch When Making Commodity Loans," *The Burroughs Clearing House* (February 1933).

Development of Warehousing and Warehouse Receipts

The storing of commodities is one of the oldest businesses in the world, dating back to the earliest Biblical times when the Egyptian Pharaoh made Joseph his warehouseman. Recorded in Genesis is the statement "And the famine was over all the face of the earth And Joseph opened all the storehouses, and sold unto the Egyptians."

Traders must have used some kind of warehouses in Alexandria, the halfway port between the East and the West and the greatest industrial and commercial city of the second century Here the necessities and the luxuries of the known world were brought for sale in the elegant shops along the *Meson Pedion*, twenty meters broad, and lined with pillared arcades for five kilometers, paved with the hardest basalt ' Here came wine from Italy, tin from Wales, amber from Sweden, pearls from the Persian Gulf bolts of silk from China, and cotton fabrics from India With a population of one million people, Alexandria was the commercial and intellectual center of the world, a veritable department store of information, the accumulator and concentrator of knowledge as a result of the free interchange of ideas which came from as far away as China [16]

By the sixteenth century Antwerp had become the commercial center of Europe Not since the days when Alexandria was pre-eminent, had so many products been assembled from so many ports or so great a proportion of the universal trade passed through a single harbor Here came the "laces of Mechlin and Valenciennes, tapestries of Brussels made after Italian designs jewels, glass and clocks, Flemish sculpture produced *en gros* for Spain or Greenland, leatherware, pewter, iron of Namur and munitions of Liege, Spanish cochineal and paints for the palettes of 'colorist' schools [17] Warehouses of some unique design must have been utilized to hold the surplus stocks of merchandise needed to carry on this immense trade with all of the ports of the known world

With the coming of the industrial revolution, the commercial and industrial leadership of Europe moved to Great Britain Important port cities provided warehouse facilities near the docks, and with the coming of the railroads, warehouses were erected near railroad terminals In

[16] Miriam Beard, *A History of the Business Man* (New York The Macmillan Company, 1938), pp 44-5
[17] *Ibid.*, p 204.

Great Britain bonded warehouses, in contrast to ordinary warehouses, date back to 1700, when provisions were made for the silks of India and Persia, whose use was prohibited at home, to be deposited in bonded warehouses for re-exportation. In 1709, pepper and, in 1742, rum, were allowed to be deposited in bond, either for subsequent re-exportation or for home consumption.

With the growth and the expansion of the American nation, there was a similar development of warehouse facilities. Our bonded warehousing system was inaugurated in 1846, when a law provided that goods might be deposited in public warehouses for a period not to exceed one year. For many years there were great differences in the forms and the practices of warehousemen, and warehouse receipts were not so generally or favorably known as at present. Two significant developments did much to remedy these difficulties. The first was the adoption of the Uniform Warehouse Receipts Act by every state in the Union. Hawaii adopted the act in 1951, and it has also been adopted by the District of Columbia and Puerto Rico. The second development was the passage of the United States Warehouse Act in 1916. In addition, the American Warehousemen's Association, with the help of the American Bankers Association, perfected standard forms of both negotiable and non-negotiable warehouse receipts. These standard forms were approved and accepted at a conference of warehousemen, shippers, bankers, and other interested groups held under the auspices of the United States Department of Commerce in Washington, D.C., in September 1924.

The Uniform Commercial Code has been adopted by eighteen states, being first passed by Pennsylvania in 1953. This Code was drawn in an attempt to unify the many statutes that govern commerce in the United States, and in time it may be accepted by all states. Although warehouse receipts are covered by this new Code, their manner of treatment is little changed from that under the Uniform Warehouse Receipts Act.

With the rapid increase in specialization and the intensive development of natural resources, commodities produced in one section of the United States sometimes must be stored and financed until they are required for use in another section. Raw materials and goods produced largely during one season of the year must be warehoused and financed until they are used later in the year. Still other commodities, such as whisky, cheese, and tobacco must be permitted to age in storage.

Commodity warehouses today are generally divided into three groups:

1. Commercial refrigerated (cold storage) warehouses, usually for

perishable goods requiring maintenance of specific temperatures for their preservation

• General merchandise warehouses, for commodities and manufactured products not requiring refrigeration

3 Field warehouses, operated by bona fide warehousemen on premises usually leased by them from the owners of goods in their custody Commercial refrigerated and general merchandise warehouses are agencies in trade and commerce for the accommodation of goods awaiting marketing and distribution or other disposition While thus being held however the goods are often used for credit purposes Field warehouses are really special commodity warehouses established solely for credit purposes, each "warehouse being confined to the custody of the raw material agricultural commodity manufactured product or other inventory for which warehouse receipts are to be issued for use as collateral Commercial refrigerated merchandise and field warehouses can be operated as customs bonded warehouses for the warehousing of imports on which the duties have not been paid and as internal revenue bonded warehouses for the storage of commodities on which internal revenue taxes have not been paid [18]

Important Facts Regarding Warehouse Receipts

The Uniform Warehouse Receipts Act provides that a warehouse of one of the three types just described must be operated by a bona fide warehouseman A bailee for hire, or bona fide warehouseman is defined as a person lawfully engaged in the business of storing goods for profit Only a bona fide warehouseman can issue a valid warehouse receipt. A valid warehouse receipt is a receipt for commodities deposited with a bona fide warehouseman and identifies the deposited commodities. [19] This receipt is in no manner an insurance policy and the banker should require the depositor of the commodities to provide adequate insurance A warehouse receipt does not guarantee grade, unless it is definitely stated on the receipt that the grade is guaranteed The services of organizations and individuals competent to pass upon quality may be obtained when grade certificates are desired

The warehouse receipt does not guarantee title for the depositor is able to transfer to the warehouseman and to the warehouse receipt

[18] *Warehouse Receipts as Collateral* (Chicago Committee on Banking Relations, American Warehousemen s Association, 1945) pp 3 4

[19] *Ibid.*, p 6.

holder only that title that he himself has; but the title that the depositor of the commodities has passes with the transfer by endorsement (without endorsement if issued to the order of bearer) of a warehouse receipt if negotiable, and by assignment of a warehouse receipt if non-negotiable. "It is an elementary principle of law that the transfer of a warehouse receipt in good faith and in the ordinary course of business operates to transfer the title to the commodities covered by such warehouse receipt."[20] In this respect, warehouse receipts and bills of lading are similar.

The Uniform Warehouse Receipts Act specifies two distinct forms of warehouse receipts: negotiable and non-negotiable. Each warehouse receipt

> . . . must embody within its written or printed terms:
>
> (a) The location of the warehouse where the goods are stored,
>
> (b) The date of issue of the receipt,
>
> (c) The consecutive number of the receipt,
>
> (d) A statement whether the goods received will be delivered to the bearer, to a specified person or to a specified person or his order,
>
> (e) The rate of storage charges,
>
> (f) A description of the goods or of the packages containing them,
>
> (g) The signature of the warehouseman, which may be made by his authorized agent,
>
> (h) If the receipt is issued for goods of which the warehouseman is owner, either solely or jointly or in common with others, the fact of such ownership, and
>
> (i) A statement of the amount of advances made and of liabilities incurred for which the warehouseman claims a lien. If the precise amount of such advances made or of such liabilities incurred is, at the time of the issue of the receipt, unknown to the warehouseman or to his agent who issues it, a statement of the fact that advances have been made or liabilities incurred and the purpose thereof is sufficient.
>
> A warehouseman shall be liable to any person injured thereby, for all damage caused by the omission from a negotiable receipt of any of the terms herein required.[21]

There are both negotiable and non-negotiable warehouse receipts.

> Definition of Non-Negotiable Receipt.—A receipt in which it is stated that the goods received will be delivered to the depositor, or to any other specified person, is a non-negotiable receipt.
>
> Definition of Negotiable Receipt.—A receipt in which it is stated that the goods received will be delivered to the bearer or to the order of any person named in such receipt is a negotiable receipt.

[20] *Ibid.*, p. 6.
[21] 3 U.L.A., *Warehouse Receipts*, Part I, § 2 (1959).

No provision shall be inserted in a negotiable receipt that it is non negotiable Such provision, if inserted, shall be void [22]

At present virtually all business firms engaged in warehouse receipt financing employ non negotiable forms The United States Government is the only large organization that still uses a negotiable warehouse receipt form

Subsidiary Warehouses

When warehouse receipts are taken as collateral for a loan, the banker usually desires the issuer of the receipt to be simply the custodian of the commodity and to have no pecuniary interest in the merchandise A warehouse operated under the control of the one who stored the merchandise is sometimes spoken of as a "subsidiary warehouse" The warehouse receipts issued under this arrangement may meet certain legal and technical requirements However, the custodian who has a proprietary interest in the stored merchandise may find it difficult to act at all times in an impartial manner He is in the position of attempting to serve two masters Consequently bankers generally prefer a disinterested, independent custodianship of merchandise held as security for loans, even though there is no question regarding the integrity and the good faith of those concerns that attempt to act as their own warehousemen [23]

[22] 3 U.L.A., *Warehouse Receipts*, Part I § 4 & 5

[23] "Warehouse Receipts issued by the depositor of commodities or issued by an agent of the depositor or by a company owned or controlled by the depositor (provided the depositor is not a bona fide warehouseman lawfully engaged in the business of storing goods for profit) are *invalid* and are known as *Subsidiary Warehouse Receipts* and the deceptive practice is known as '*Subsidiary Warehousing*'

"Subsidiary Warehouse Receipts issued by a dummy warehouse corporation or issued by the borrower or issued by the borrower's shadow are invalid and will not protect a banker against third party claims or other contingencies however, a bona fide warehouseman as defined in the Uniform Warehouse Receipts Act, can issue a valid Warehouse Receipt against commodities which he owns or in which he owns an interest provided he includes on such Warehouse Receipt a statement of his ownership in the commodities

"When a banker holds as collateral a Warehouse Receipt issued by a subsidiary warehouse company he is hoding merely a piece of script termed with dignity a Warehouse Receipt Therefore a banker should insist that the warehouseman issuing Warehouse Receipts on which he anticipates extending credit is not merely a puppet or, in reality, the borrower or the borrower's shadow but is an independent, disinterested custodian as defined by the Uniform Warehouse Receipts Act

"The control of commodities covered by Subsidiary Warehouse Receipts remains in the hands of the depositor either directly or indirectly This is contrary to good business, defeats a banker's protection against third party claims and does not comply with the requirements of the Uniform Warehouse Receipts Act." *Warehouse Receipts as Collateral* (Chicago Committee on Banking Relations American Warehousemen's Association 1945), pp 4 5

Figure 86 Standard Form of Non-Negotiable Warehouse Receipt, approved by the American Bankers Association, the American Warehousemen's Association, and the Department of Commerce (*actual size: 8½" x 13"*)

51

LAWRENCE WAREHOUSE COMPANY

LAWRENCE SYSTEM

NOT INSURED

ORIGINAL WAREHOUSE RECEIPT **No.** F 52219

DATE

RECEIVED EX

FOR STORAGE IN

WAREHOUSE NO

LOCATED AT

STREET

SUBJECT TO ALL THE TERMS AND CONDITIONS CONTAINED HEREIN AND ON THE REVERSE HEREOF FOR THE ACCOUNT OF AND TO BE DELIVERED WITHOUT SURRENDER OF THIS WAREHOUSE RECEIPT UPON WRITTEN INSTRUCTION OF

FILL IN

WAREHOUSE RECEIPT HOLDER

Depositor's Declared Values for which the Warehouseman Assumes No Responsibility

CODE NO	ITEM	NO UNITS	SAID TO BE OR CONTAIN	UNIT VALUES	EXTENSION OF UNIT VALUES

DO NOT ACCEPT THIS WAREHOUSE RECEIPT IF ANY CORRECTION OR ERASURE APPEARS HEREON

SUBJECT TO LIEN FOR STORAGE HANDLING AND OTHER CHARGES AS PER CONTRACT AND LEASE WITH THE INDUSTRY SERVED

TRANSFERS OF MERCHANDISE NOT COMPLETE UNLESS MADE UPON THE BOOKS OF THE WAREHOUSE COMPANY

LAWRENCE WAREHOUSE COMPANY

PER

BONDED WAREHOUSE MANAGER

RECORD OF RELEASES AND BALANCE ON HAND

ITEM 1					ITEM 2					ITEM 3				
Date	Release No	Delivered	Balance	Value Balance	Date	Release No	Delivered	Balance	Value Balance	Date	Release No	Delivered	Balance	Value Balance

ITEM 4					ITEM 5					ITEM 6				
Date	Release No	Delivered	Balance	Value Balance	Date	Release No	Delivered	Balance	Value Balance	Date	Release No	Delivered	Balance	Value Balance

ITEMS 7 8 9 10 11 AND 12 ON REVERSE SIDE OF THIS SHEET

(Over)

F 52219

Figure 87A Standard Form of Negotiable Warehouse Receipt The form above is the first, or office, copy The original is identical to the upper half but there is no record of releases and balance on hand.

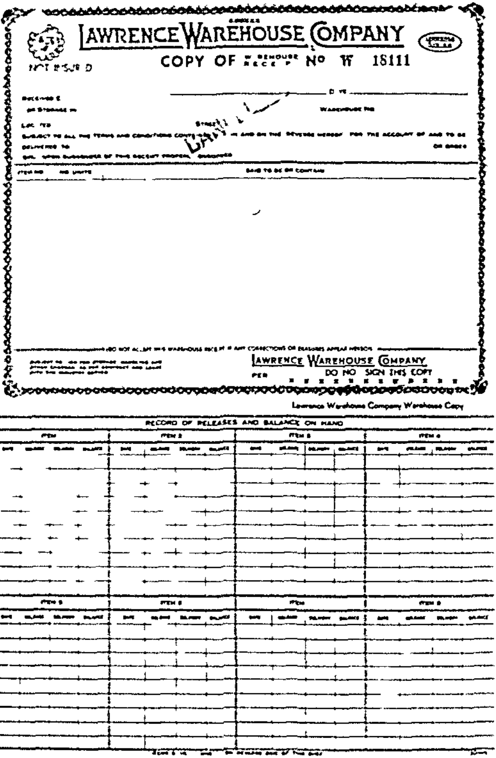


Figure 87B Standard Form of Negotiable Warehouse Receipt (*reverse of first copy*)

RECORD OF RELEASES AND BALANCE ON HAND

ITEM 9				ITEM 10				ITEM 11				ITEM 12			
DATE	RELEASE	DELIVERY	BALANCE	DATE	RELEASE	DELIVERY	BALANCE	DATE	RELEASE	DELIVERY	BALANCE	DATE	RELEASE	DELIVERY	BALANCE

ADDITIONAL RELEASES ITEM No				ADDITIONAL RELEASES ITEM No				ADDITIONAL RELEASES ITEM No				ADDITIONAL RELEASES ITEM No			
DATE	RELEASE	DELIVERY	BALANCE	DATE	RELEASE	DELIVERY	BALANCE	DATE	RELEASE	DELIVERY	BALANCE	DATE	RELEASE	DELIVERY	BALANCE

TERMS AND CONDITIONS

The warehouseman shall not be liable for loss damage or delay caused by Acts of God war civil or military authority insurrection riot strikes labor disputes fire sprinkler leakage flood wind storm vermin change of temperature variations in weights or for loss in weight by reason of defective or insufficient containers unless such loss damage or delay is caused by the failure of the warehouseman to exercise the ordinary care and diligence required by law

The receipt storage and delivery of merchandise is subject to the Uniform Warehouse Receipts Act and all rules and regulations promulgated by *Federal State and Municipal Government Governmental Agency or Instrumentality*

Lawrence Warehouse Company has no financial interest in the merchandise covered by this Warehouse Receipt (except warehouseman's lien) and Lawrence Warehouse Company is NOT INTERESTED DIRECTLY OR INDIRECTLY in the finances or management of the depositor for whose benefit this receipt is issued

The location of merchandise as shown on this warehouse receipt is not given for insurance purposes and Lawrence Warehouse Company disclaims all liability *for error or insufficiency in the* description of the location shown if such location is so used

The face hereof is a copy of original Negotiable Warehouse Receipt bearing the same number and date hereof *This copy is for purposes of certification and record only* and is not a Warehouse Receipt Any references on this copy to the face of such original Negotiable Warehouse Receipt or the face of this copy includes only that portion of the original Warehouse Receipt or this copy above the words Lawrence Warehouse Company Office Copy set forth on the face hereof

• • • • • •

I (We) the undersigned certify and guarantee that the face hereof is a true copy of the face of the Lawrence Warehouse Company original Negotiable Warehouse Receipt bearing the same number and date hereof and this copy has been compared by us with the original

I (we) the undersigned hereby certify and guarantee that I (we) are the legal owners of the commodities set forth on the face hereof and that the quantity and quality stated thereon are correct and that I (we) have delivered the same as of the date hereof to the Lawrence Warehouse Company for warehousing purposes in accordance with the terms of our storage agreement with them I (we) hereby authorize the Lawrence Warehouse Company to issue a Negotiable *Warehouse Receipt* bearing the same number and date hereof covering the above mentioned commodities in the name of

____________________ of ____________________

Depositor____________________

By____________________

• • • • • •

I the undersigned certify and guarantee that the face hereof is a true copy of the face of the Lawrence Warehouse Company original Negotiable Warehouse Receipt bearing *the same number* and date hereof and this copy has been compared by me with the original

I hereby certify that I received on ________________ 19____ into my custody as

Bonded Warehouse Manager of the Lawrence Warehouse Company at its________________

____________________ Warehouse No.________

the commodities set forth on the face hereof and have issued an original Negotiable Warehouse Receipt covering the above mentioned commodities Such original Negotiable Warehouse Receipt was issued and signed by me and such commodities will be released by me from the above mentioned *warehouse only in accordance* with Lawrence Warehouse Company written instructions which I have heretofore received or may hereafter receive I realize that to issue or sign such original Warehouse Receipt and the copies thereof or to release such commodities otherwise than in accordance with such written instructions violates the terms of my employment by the Lawrence Warehouse Company and constitutes a fraud upon that Company and the holders of its Warehouse Receipts

Lawrence Warehouse Company Bonded Whse Mgr____________________

• • • • • •

INSTRUCTIONS TO LAWRENCE WAREHOUSE COMPANY BONDED WAREHOUSE MANAGER

IMPORTANT The Lawrence Warehouse Company Bonded Whse Mgr making out and signing the original Negotiable Warehouse Receipt bearing the same number and *date hereof must forward* this signed copy of such Warehouse Receipt ON THE DATE HEREOF to the Lawrence Warehouse Company office the address of which is included in its written instructions addressed to such Bonded Warehouse Manager

Field Warehousing

For many years warehouse receipts were used as collateral only in connection with merchandise stored in our larger cities, particularly in the warehousing of cold storage products and grain. Then about 1900 the idea occurred that warehousing facilities could be brought to the storer; in other words, the warehouse might go to the commodity instead of the commodity's going to the warehouse. This is the essence of field warehousing.[24]

The average life of field warehouses is three to five years, except in industries characterized by highly fluctuating seasonal working capital needs, wherein the average life is much longer. The depositing-borrowing concerns either perfect arrangements with new warehousemen, or frequently they use a field warehouse receipt aarrngement temporarily until they are able to secure credit on other bases. In some cases field warehousing is discontinued because the particular circumstances that made advantageous the acquisition of an above-normal inventory have disappeared.

It is now estimated that the six principal field warehouse companies in the United States operate upward of five thousand field warehouses, while small local concerns operate one hundred at most. The average annual amount of credit outstanding and secured by field warehouse receipts is currently running near $500,000,000. Although until a few years ago field warehouses were concentrated primarily in the Central and Pacific states, today they are nation wide in scope. Any storeable commodity may be warehoused in the field, and in the past these products have ranged from automobiles to yarn, from wine to bus bodies.

While the value of deposits in a given warehouse is likely to vary greatly through each year, the typical field warehouse contains merchandise worth, on the average, between $25,000 and $100,000, and the typical loan against the warehouse receipts is approximately two thirds of the value of the deposits.

Commercial banks originally monopolized the financing of field warehouses, but recently other financial intermediaries have moved into the

[24] Students of the subject of field warehousing will find it of interest and value to read Neil H. Jacoby and Raymond J. Saulnier, *Financing Inventory on Field Warehouse Receipts* (New York: National Bureau of Economic Research, Inc., 1944); Wesley J. Schneider, *Field Warehousing as a Facility for Lending Against Commodities* (New York: The Macmillan Company, 1941); Dominick J. Mastellon, *Administration of Field Warehouse Loans* (paper prepared for the Graduate School of Banking of the American Bankers Association, 1958).

field. Currently it is estimated that commercial banks appear as lenders upon the receipts of seven out of every ten field warehouses, two are finance companies or factors, and one is a manufacturer financing his distributor.

The warehouseman leases a warehouse at the place where the merchandise is produced, manufactured, or processed, and sets up what may be called a "branch warehouse." Unnecessary movements of bulky and heavy commodities are thereby avoided. The leased warehouse generally belongs to the storer. A warehouseman or agent is placed in charge, and signs are placed inside and outside of the warehouse to inform the public that a warehouse is being operated. The pledged merchandise is segregated and is stored in individual stacks. A special card on each stack shows the quantity and nature of the merchandise and to whom it is pledged. Warehouse receipts are issued for the merchandise, which is kept under lock and key. The agent in charge releases the merchandise only upon written authority of the holder of the warehouse receipt. The agent and other employees are bonded to guard against the release of any merchandise without proper authority. In addition, the warehouseman may make frequent audits to check the inventory, the condition of the commodities, and the general operation of the field warehouse. The field warehouseman should carry sufficient insurance against any liability growing out of the Uniform Warehouse Receipts Act. Over the last thirty years field warehousing has developed into a large business and has been used in over 150 industries and for such widely different products as olives, outboard motors, and oyster shells. This development has provided new possibilities for the banker to make loans on an adequately secured basis.

Illustration of Loan on Warehouse Receipts

John Graham & Sons is a partnership engaged in storing and wholesaling eggs. The concern buys eggs in the spring, stores them until fall, and then sells them to retail stores. The partnership has banked at the Arden National Bank of Chicago for eight years. The business has shown steady progress, the tangible net worth having increased in that period from $52,000 to approximately $84,000. During the same period the net working capital has grown from $23,000 to $54,000.

This firm has regularly borrowed from its bank during the spring months of each year. In March of the current year one of the partners again approached Henry T. Smith, vice-president of the bank, requesting

the privilege of borrowing $15 000 during the heavy egg producing season, the loan to be secured by warehouse receipts. At the time of this request eggs were costing approximately $6 00 a case By agreement, the loan was set at 70 per cent of the cost of the eggs, as determined by the market. In view of the satisfactory record of the company, the market ability of the collateral and the fact that the firm maintained average balances of approximately $6 000 the request was readily granted

CHATTEL MORTGAGE LOANS

Chattels as Security

A banker desiring to secure his position often resorts to a chattel mortgage The asset pledged is usually a fixed asset such as automobiles, trucks machinery, or other such equipment In general chattel mortgages are most suitable for fixed equipment items if they are not intended for resale in contrast to continuous inventory financing Where an item is intended for resale the pledged inventory should be described in detail in the mortgage and no substitution should be allowed without express permission of the mortgagee Several states hold that a chattel mortgage on goods daily exposed to sale is void

The lender should acquaint himself with the laws respecting chattel mortgage financing not only in his own state but also in the state or states where the mortgaged chattel is lodged The chattel mortgage in some jurisdictions is regarded as an absolute transfer of title and subject only to the condition of its being revested in the mortgagor upon liquidation of the debt Other jurisdictions consider the mortgage as nothing more than creating a lien upon the chattel in favor of the lender Of course the mortgagor has possession and full use of the property in either situation

The amount of money to be loaned and the terms of repayment should be predicated not only on the credit worthiness of the prospective borrower but also on the type of equipment or merchandise to be mortgaged The lender should be cognizant of the value of the collateral at the inception of the loan and at maturity A factor to be considered is the salability or marketability of the collateral Some goods have limited markets and therefore are difficult to liquidate if repossessed Other types of merchandise depreciate quickly because of their quality style or economy in usage

Chattel mortgage financing lends itself to the banker desirous to assist the small businessman who perhaps is not qualified for unsecured financing to the large businessman who requires financing in excess of his un

secured financing arrangements; and to the individual purchasing an automobile, a boat, an appliance, or other tangible items.

Illustration of Chattel Mortgage Loan Secured by Equipment.—Jones Printing Company, a successful midwestern printing company, contemplates the addition of a four-color offset press, which would enable them to expand their business and to increase their net profit by an estimated 15 per cent. The new press is to be installed in their branch in another state. They have banked with the Old National Bank, Milford, Minnesota, for fifteen years and carry an account that last year averaged $55,000. In the past they have borrowed from the bank on an unsecured basis amounts up to $30,000 to meet seasonal requirements or to finance unusually large jobs. The new equipment completely installed will cost $90,000. Inasmuch as the amount was somewhat larger than their usual requirements and was in essence a capital loan rather than a working capital loan, Mr. Smith, vice-president of the bank, decided to send his auditors out to examine the financial records of the company as well as their plant and equipment.

On the basis of the investigation, Mr. Smith granted the company a three-year loan repayable $2,500 a month plus interest. The loan was secured by a chattel mortgage on the new equipment. Mr. Smith was familiar with the laws of the various states regarding the filing and recording of chattel mortgages. Jones Printing Company executed a note and chattel mortgage which contained a complete description of the equipment, including all accessories. The proper filing of the chattel mortgage had the effect of notifying third parties of the bank's lien on the press.

Illustration of Chattel Mortgage Loan Secured by Cattle.—Mr. John Morgan owns a two-hundred-acre farm fifty miles southwest of Milford, Minnesota. He is a man forty-five years of age and has been a farmer all of his adult life. The farm buildings are about fifteen years old but in excellent condition. His machinery has been well cared for and is in first-class condition. Mr. Morgan's farm is quite diversified, with a large part of his income derived from the sale of cream which he takes daily to the local creamery. He produces corn and small grain for cattle feed or sale. The farm is encumbered with a $5,000 mortgage.

Mr. Morgan approached his banker, Mr. Tom Grayson, vice-president of the Farmers Commercial Bank, for a $5,000 feeder loan. The loan would be secured by a chattel mortgage on his farm machinery and all of his livestock, which consisted of eighty-five steers and twenty cows. The stock had a current market value of approximately $12,500. Mr. Morgan was confident that he could liquidate the loan in part from his

regular weekly cream check and in part from the sale of some of his steers. Considering Mr Morgan's past experience with the bank and his success in operating his farm Mr Grayson made Mr Morgan the $5 000 loan.

INTERIM FINANCING OF MORTGAGES[25]

The use of commercial bank credit for interim financing is confined largely to mortgage bankers A mortgage banker, as defined by the Mortgage Bankers Association of America is an organization having as its *principal* activity the origination and servicing of mortgage loans for investors This definition would exclude those entities that have been organized only as a supplement to some other activity While mortgage company affiliates or subsidiaries, of home builders or prefabricated home manufacturers would be excluded from new membership in the M.B.A their operations are basically similar to those of mortgage bankers Thus the credit standards for loans to such captive companies are basically the same as those applicable to mortgage bankers

Background

Prior to 1930 most mortgages, particularly those on residential properties were for three to five year maturities and seldom provided for amortization of principal [26] There was little uniformity among lenders as to terms and provisions of documents, appraisal techniques or credit standards for borrowers These mortgage loans were usually sold to individual investors, although commercial banks had fairly substantial amounts in their portfolios

The depression of the early thirties and the resultant widespread defaults on mortgage obligations forcibly demonstrated that these short term mortgages were not desirable investments Few borrowers were able or prepared to meet their obligations in full at maturity Mortgage loans fell into such bad repute that for a time national banks were prohibited from making loans secured by liens on real estate With the advent of the federally chartered savings and loan associations and the inception of the FHA Mortgage Insurance Program in 1934 a sounder

[25] This statement on real estate mortgages and interim financing of mortgages was prepared by Edgar M McKinstery vice president of The First National Bank of Chicago

[26] Saul B Klaman, "Postwar Rise of Mortgage Companies" (National Bureau of Economic Research Inc., 1959)

approach to mortgage lending came about, providing for longer-term but fully amortized loans. The FHA program particularly standardized mortgage documents, provided minimum property and appraisal standards, established minimum credit requirements for borrowers, and minimized the risk to mortgage lenders through its insurance provisions. The foregoing contributed to the creation of a mortgage market more national in scope, and large institutional investors, especially life insurance companies, were attracted to this new investment medium.

However, the credit requirements of local borrowers frequently exceeded the supply of funds available in their community. This led to the appointment of experienced local mortgage companies as loan correspondents for national investors. Mortgage bankers serving as loan correspondents have thus become important links in facilitating the flow of mortgage investment capital across state lines.

The mortgage banker is typically a closely held corporation with a relatively modest net worth in relation to the volume of business handled. The principals should be specialists in the muddle of local laws relating to real estate and thoroughly familiar with the economic situation prevailing in their community. Through their close relationships with institutions for which they act as correspondents, these mortgage bankers have access to a reservoir of investment funds not normally available to the individual borrower.

Most investors choose to purchase completed mortgage packages and are unwilling to make construction loans or advances as work progresses. As a result mortgage bankers are expected to provide the construction financing on mortgages that they have originated. Thus, their own limited working capital must be augmented by liberal credit accommodations from commercial banks.

Techniques

While there is some seasonal fluctuation in the volume of business and also in the amount of credit required by the average mortgage banker, most are indebted to banks continuously in amounts exceeding their working capital. Thus, most commercial banks prefer to extend credit only on a fully secured basis, taking as collateral assignments of mortgage notes and evidences of lien covering the properties being financed by the mortgage banker.

A principal reason for taking collateral is to provide the lender with a preferred position in the event of insolvency or bankruptcy. The absence

of any other substantial creditor in most mortgage companies may raise the question of the need for collateral in the extension of credit to mortgage bankers. One answer is that the banks are usually providing the major portion of funds needed to originate and carry mortgages in process hence it is only prudent to maintain a watchful eye on the types of loan being originated to examine the investors "take-out" or purchase, commitments, if any and to see that each mortgage pledged as collateral turns in a reasonable length of time This can be accomplished by requiring physical possession of all documents necessary to make good delivery to an investor

Within the broad category of "collateral loans secured by mortgages" are a number of variations, including the following major types [17]

1. Short term collateral loans secured by committed mortgages on completed properties.
2. Six-to-nine month collateral loans secured by committed mortgages on properties under construction.
3. Collateral loans secured by committed mortgages on completed properties which mortgages, by agreement, need not be delivered for a specified period Such loans are usually made to accommodate a reliable and responsible investor whose forward commitments and flow of investment funds are temporarily out of balance
4. Collateral loans of six to nine months secured by uncommitted mortgages on completed properties.
5. Collateral loans of one year or less secured by uncommitted but insured or guaranteed mortgages where the lending bank, by agreement, automatically acquires title to the collateral at the maturity of a non recourse note

A smaller bank that finds the credit needs of its mortgage banker customer exceed its legal lending limit and who does not wish to arrange an overline with its metropolitan correspondent, may elect to become successor mortgagee by a recorded assignment from its mortgage customer This technique while somewhat cumbersome, does spread the lending limit over a number of borrowers The actual details—such as disbursements, recordings, insurance and title insurance—are handled under agreement by the originating mortgage company Some banks will choose to purchase uncommitted mortgages on completed properties subject to a repurchase agreement extending over a period of one to two years. Such purchases are usually made at a price ranging from one to five points below the existing market for mortgages of the same general type and quality The repurchase option permits the seller to reacquire and sell elsewhere if a better price is obtainable

[17] Courtenay J Whedbee "Interim Financing of Real Estate Mortgage Loans" (American Bankers Association, 1956)

In the case of large FHA rental project mortgages under such sections as 608, 207, and 213, the FHA administrative regulations provide that assignments require the prior approval of the FHA Commissioner. Since such approval has been granted only infrequently, whereas participations between mortgage bankers and commercial banks are readily confirmed, many banks follow this lending procedure in order to assist their mortgage banker customer. Administrative details are handled by the customer under reasonable supervision by the bank.

National banks must be certain that they participate pro rata in each and every construction advance under these mortgages, due to the limitations of Section 24 of the Federal Reserve Act. This provides that banks may participate in an original mortgage, but may not purchase a participation in a loan once made, unless the effect thereof is to make the bank the sole owner of the mortgage.

Mechanics

Loans described earlier as "collateral loans secured by mortgages" make up the bulk of commercial bank credit to mortgage bankers. The discussion of mechanics, therefore, will be limited to this category. State laws govern, and there are variations from state to state, but in general the following procedure will be found satisfactory.

Collateral Note.—Most banks will find that their own form of collateral note will serve very well. Although bank counsel may recommend that a separate note be used and related to each specific piece of mortgage collateral pledged, practical considerations lead many banks to consider all collateral as security for all notes.

Endorsement of Mortgage Note.—Except in the case of bearer instruments, notes should be endorsed in blank by the pledgor as follows:

Pay to the order of

____

Without Recourse
Reliable Mortgage Corporation
by James W. White, President

Upon final delivery of the loan to an investor, the name of such investor may be inserted into the endorsement.

Mortgage Assignment.—Except in the case of trust deeds, which are used in some states, mortgages or bonds require written assignments which may take the form in Figure 88. While some banks may require

that assignments be recorded in their favor, a majority do not for the previously mentioned reason that there are no other major creditors.

Certificate of Initial Disbursements.—Advances under construction mortgages are made piecemeal against draw requests by the contractors and are properly supported by waivers of lien. The lending bank should

Figure 88 Mortgage Assignment

MORTGAGE ASSIGNMENT

Chicago, Illinois

________________ 19___

The undersigned, ________________________ an Illinois Corporation, does hereby sell, assign, transfer, and set over unto THE FIRST NATIONAL BANK OF CHICAGO a national banking association, a mortgage in the amount of $____________

made by ____________________________________

dated ______________ and recorded in ______________ County, ________

as Document No. ______________, together with all rights of the undersigned in any way pertaining to said mortgage and now or hereafter existing by virtue of insurance or otherwise, and authorizes said Bank or any officer thereof as the Agent of the undersigned, to execute and deliver to said Bank such other and further definitive and supplemental assignments, in forms satisfactory to said Bank, pertaining to said mortgage as it in its uncontrolled discretion may from time to time determine

By ________________________

Attest:

____

have some form of written instrument from its customer declaring under oath and seal the amount of money disbursed to contractors on behalf of the owner to the date of initial pledge. The form in Figure 89 may be used for this purpose. Note that it incorporates a form of assignment so that separate individual assignments of construction mortgages will not be required.

Certificate of Additional Disbursements.—As additional pay-outs are made by the mortgage banker on construction mortgages already pledged, a positive declaratory statement of the amount of such advance is required by the bank to support additional loans. The form in Figure 90 should be adequate in most instances.

Insurance.—With regard to builder's risk, hazard insurance, and/or fire and extended coverage policies, some banks require that they be named co-beneficiary in a loss-payable clause, as additional protection while the

mortgage is pledged to them. This necessitates execution of releases upon the sale of and receipt of payment for each piece of mortgage collateral involved. For practical considerations again, a majority of banks waive this requirement.

Figure 89 Certificate of Initial Disbursements

The First National Bank of Chicago
Chicago, Illinois

Gentlemen

The undersigned, in connection with a proposed loan from you, hereby certifies that disbursements have been made on mortgage loans, the office loan number and the amount of each such disbursement being set forth below

Office Loan No	Amount of Disbursements	Office Loan No	Amount of Disbursements	Office Loan No	Amount of Disbursements

Total of above disbursements ______________

In connection with each disbursement shown above, as having been made by us, we represent and warrant that we have examined authentic affidavits of each contractor and each owner with reference to all sub-contractors and parties furnishing labor or materials under each contract, and authentic lien waivers from each of them, and it appears from these affidavits and lien waivers, all of which are in our possession, and from the amount of the remaining disbursements, that there are sufficient funds to complete the construction of each building free and clear of all claims and liens for labor, material, or otherwise, and that such funds, with other funds that have been paid us, will be sufficient to pay all items necessary to procure purchase by the committer, of each of the mortgages represented by numbers set forth above

We further represent and warrant that construction of the buildings at each of the properties, represented by numbers set forth above, has been inspected by us and fully meets any and all requirements of the permanent investor, F H.A. or V.A., as the case may be In the case of single family residences, the buildings are at least under roof with plumbing and wiring roughed in.

The undersigned, ______________________, an Illinois Corporation does hereby sell, assign, transfer, and set over unto THE FIRST NATIONAL BANK OF CHICAGO, a national banking association, and its successors and assigns, mortgages bearing the above listed office loan numbers, together with all rights of the undersigned in any way pertaining to said mortgages and now or hereafter existing by virtue of insurance or otherwise, and authorizes said Bank, or any officer thereof, as the Agent of the undersigned, to execute and deliver to said Bank such other and further definitive and supplemental assignments, in forms satisfactory to said Bank, pertaining to any or all of said mortgages as it in its uncontrolled discretion may from time to time determine

Yours very truly,

____

ATTEST

By ______________________
Official Signature

____
Chicago, Illinois

____

At the time each piece of collateral is pledged to the bank, together with the previously mentioned forms, evidence of condition of title should also be submitted in the form of a preliminary title search, a mortgagee's title guaranty policy, or an attorney's abstract. A review of

Figure 90 Certificate of Additional Disbursements

The First National Bank of Chicago
Chicago, Illinois

Gentlemen

The undersigned, in connection with a proposed loan from you, hereby certifies that additional disbursements have been made on account of mortgage loans previously assigned to you and on which previous pay-outs have been certified to you. Our office loan number and the amount of each such additional disbursement are set forth below

Office Loan No.	Amount of Disbursements	Office Loan No.	Amount of Disbursements	Office Loan No.	Amount of Disbursements

Total of above disbursements ______________

In connection with each disbursement shown above, as having been made by us, we represent and warrant that we have examined authentic affidavits of each contractor and each owner with reference to all sub-contractors and parties furnishing labor or materials under each contract and authentic lien waivers from each of them, and it appears from these affidavits and lien waivers, all of which are in our possession and from the amount of the remaining disbursements, that there are sufficient funds to complete the construction of each building free and clear of all claims and liens for labor material, or otherwise and that such funds, with other funds that have been paid us, will be sufficient to pay all items necessary to procure purchase by the committee of each of the mortgages represented by a number set forth above

We further represent and warrant that construction of the buildings at each of the properties, represented by numbers set forth above, has been inspected by us and fully meets any and all requirements of the permanent investor, F.H.A. or V.A., as the case may be

Yours very truly

____

By ____________________
Official Signature

Chicago, Illinois

____

one of the above should indicate that the mortgage being presented as collateral is a good and prior first lien on the property.

It is suggested that the lending bank check the status of its collateral against the ledger records of its mortgage banker borrower not less than once each year. Particular emphasis should be placed upon construction mortgages in process, and every effort should be made to determine that there remain sufficient undisbursed funds to complete the planned improvements free and clear of all liens. Waivers of lien should be on hand to cover all disbursements previously made, and a spot check should be made of canceled checks representing such disbursements.

Those who do the checking should also review the borrower's entire procedure for handling construction loans.

Summary

It is acknowledged that commercial banks that are active in this type of lending are making a valuable contribution to the betterment of their community. Properly handled, these loans provide a reasonable degree of safety and are usually made at an attractive rate. Since most mortgage banker customers service the loans which have been sold to investors and are permitted to control insurance and real estate tax escrow funds, the lending bank is usually favored with balances that are more than commensurate with the amount of credit extended. It should be recognized, however, that the expansion of this type of credit has taken place during a period when national banks were able to make many loans indirectly via mortgage bankers which could not legally be made directly because of the limitations of Section 24 of the Federal Reserve Act. Recent legislation has liberalized the terms of this act sufficiently that many national banks may now choose to originate mortgages themselves that formerly were handled by their mortgage banker customers. This, of course, calls for a reappraisal by top management of the bank's lending policies, together with a re-evaluation of personnel to determine their capacity to handle such new responsibilities.

INSURANCE POLICY LOANS[28]

For a period of years the number of loans secured by the assignment of the cash surrender value of life insurance was extremely limited, and

[28] The problems involved in making loans against the cash surrender value of life insurance are carefully discussed and analyzed in an article by Paul H. Bowdre, of the First National Bank of Memphis, Memphis, Tenn., in the Robert Morris Associates' *Bulletin* (October 1958), pp. 25–34.

the total now is not particularly large in comparison to the over all total of bank loans. Formerly, insurance was taken largely to obtain additional protection on loans already made. The pressure during the depression of the nineteen thirties, resulting from low interest rates and a decline in earning assets, made it imperative that banks find every available source of earnings One result was this increase in insurance loans There is still a difference of opinion regarding the desirability of making a loan of this type, particularly in any substantial volume as usually it is a continuing loan, and a request for reduction and repayment is generally looked upon with disfavor by the borrower unless a definite understanding is had at the time the loan is made

Because of financial difficulties in times of stress, many individuals borrow against the cash surrender value of their life insurance policies. This is true where ready cash is needed by both individuals and companies carrying large policies on the lives of their principal officers Most loans of this nature are carried by the insurance companies unless the bank interest rate is more favorable

When banks make loans of this character they must look beyond the mere fact that an earning asset is being acquired Some consideration should be given to the purpose of the loan and to a definite program of liquidation If there is no income available for the eventual retirement of the loan, the banker may find himself with a credit that can be liquidated only by cashing the value of the life insurance or upon the death of the borrower

Considerable detail is involved in handling such loans The banker must find out, among other things, that the policy is assignable, who has the right to assign the policy, the amount of cash surrender value, and whether the premiums are paid to date Some insurance companies insist that their own forms of assignment be used, some banks prepare their own assignment and follow in a general way the questionnaire (Figure 91) and the assignment form (Figures 92A and 92B) prepared by the American Bankers Association The questionnaire (Figure 91 or one similar) should be forwarded to the insurance company and received in turn, with all questions answered before the preparation of the assignment Whether the banker prepares an assignment that is acceptable or whether the insurance company s form is used the assignment must be forwarded to the home office of the insurance company for acceptance and a copy returned to the bank before the assignment is valid and binding When the borrower repays a loan under this arrangement, it is

necessary to release the bank's interest in the policy; this is accomplished by the execution and delivery to the insurance company of a form of release as illustrated (Figure 93). To assure the bank that the policy continues in force during the period of the loan, the borrower should be

Figure 91 Life Insurance Assignment Questionnaire

Form No. 16

FORM DESIGNED PRINTED AND DISTRIBUTED BY
BANK MANAGEMENT COMMISSION
AMERICAN BANKERS ASSOCIATION

LIFE INSURANCE ASSIGNMENT QUESTIONNAIRE

(Prepare in triplicate and send two copies to company as assignments are taken)

Date__________

To__________
INSURANCE COMPANY

Address__________City__________State__________

From__________
BANK

Address__________City__________State__________

Please supply the following information regarding your Policy No __________ issued to__________

__________ and return in stamped envelope enclosed

Request authorized by

____
TYPE OR PRINT

____
SIGNATURE OF INSURED OR OWNER

____
ADDRESS

By__________
BANK AUTHORIZED SIGNATURE

____
TITLE

1. Premium paid to__________
DATE
2. Amount of premium due Annually__________Semiannually__________Quarterly__________Monthly__________
3. Amount of prepaid premiums, if any $__________
4. Cash value as of__________ $__________(Dividends excluded, loans not deducted)
ANNIVERSARY DATE
5. Cash value of accumulated dividends $__________
6. Policy loans (if none, so indicate) $__________
Date of your loan__________Rate__________%
7. Any existing assignments on record? Yes ☐ No ☐
If so, to whom?__________
8. In the event of premium default, the following option has been designated as automatic __________
9. Name of present beneficiary if different from original named in policy __________
____
10. Death settlement basis Lump sum ☐ Optional mode ☐ (Describe) __________
____
11. Agency or branch office through which premiums are currently being paid__________
____
12. Will you send duplicate notice of premiums due to assignee? Yes ☐ No ☐
13. Will you send duplicate receipts for payments to assignee? Yes ☐ No ☐
14. Will you notify us at the end of grace period if premiums are not paid? Yes ☐ No ☐

Date of Insurance Company's reply

____

____
INSURANCE COMPANY

By__________
AUTHORIZED SIGNATURE

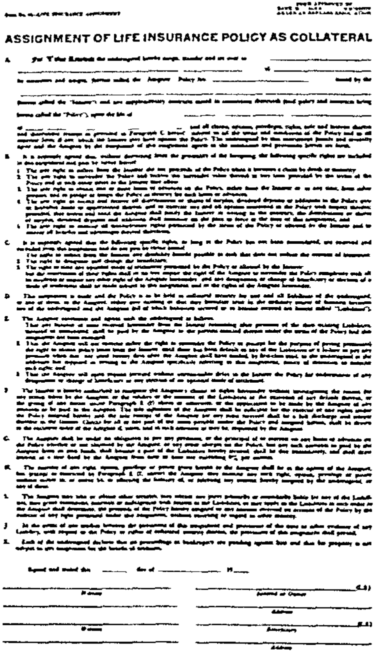
COPYRIGHT [illegible] AMERICAN BANKERS ASSOCIATION

BMC 212 1 [illegible]

required to forward all paid premium receipts to the bank to be filed with the policy.

An illustration of this kind of loan is the case of Dr. James Brown, who had a growing medical practice in a small city for twenty years.

Figure 92A Life Insurance Assignment Form (*front*)



He owned a moderate home clear of encumbrances, and his income averaged in excess of $12,000 per year. Dr. Brown wished to refurnish his office and to purchase more modern equipment at a total cost of $3,000. He could make these purchases on the instalment plan, but preferred to

Figure 92B Life Insurance Assignment Form (*reverse*)

INDIVIDUAL ACKNOWLEDGMENT

STATE OF ______ }
COUNTY OF ______ } ss

On the ______ day of ______ 19 ______ before me personally came ______ *to me known to be the individual* ___ *described in and who* executed the assignment on the reverse side hereof and acknowledged to me that ___ he ___ executed the same

______
Notary Public

My commission expires______

CORPORATE ACKNOWLEDGMENT

STATE OF ______ }
COUNTY OF ______ } ss

On the ______ day of ______ 19___, before me personally came ______ ______, who being by me duly sworn, did depose and say that he resides in ______ that he is the ______ of ______ the corporation described in and which executed the assignment on the reverse side hereof that he knows the seal of said corporation, that the seal affixed to said assignment is such corporate seal that it was so affixed by order of the Board of Directors of said corporation, and that he signed his name thereto by like order

______
Notary Public

My commission expires______

. . . . .

Duplicate received and filed at the home office of the Insurer in ______ this ______ *day of* ______ 19___

______

By______
Authorized Officer

NOTE Where executed by a corporation, the corporate seal should be affixed and there should be attached to the assignment a certified copy of the resolution of the Board of Directors authorizing the signing officer to execute and deliver the assignment in the name and on behalf of the corporation.

borrow at the bank to reduce carrying costs. He placed his problem before John B. Warren, vice-president of the Second National Bank in his city, where he had carried an account with balances averaging between $900 and $1,200 for sixteen years. Dr. Brown explained that he was able to pay $800 down on the purchase but would like to borrow $2,200 against the cash surrender value of his life insurance policies of $3,575 to pay the balance. He would retire the loan at the rate of $200 monthly. In the circumstances Mr. Warren agreed to extend the credit as soon as the assignment could be completed.

Figure 93 Release of Assignment of Life Insurance Policy

RELEASE OF ASSIGNMENT OF LIFE INSURANCE POLICY

For Value Received, all right, title and interest of the undersigned assignee in and to policy

No.__________ issued by____________________

on the Life of____________________ is hereby relinquished and released.

Signed and sealed this________ day of____________, 19___

[CORPORATE SEAL]

____

By____________________

Attest____________________

• • • • • •

CORPORATE ACKNOWLEDGMENT

STATE OF____________ } ss
COUNTY OF____________

On this________ day of____________ 19____, before me personally came____________

____________________ of ____________________

and____________________ of ____________________

to me known, who, being by me duly sworn, did jointly and severally depose and say that they are respectively the ____________ and ____________

of the____________________

the Corporation described in and which executed the foregoing instrument; that they know the seal of said Corporation; that the seal affixed to this instrument is said corporate seal; and that they have signed their names to said instrument and caused said corporate seal to be affixed thereto as the act and deed of said Corporation.

My commission expires____________ ____________________

SUGGESTED READINGS

(Mortgage Financing)

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Klaman, Saul B *Postwar Rise of Mortgage Companies*. National Bureau of Economic Research, Inc., 1959

Schneider, James F *Construction Loans for Your Short-Term Portfolio*. American Bankers Association, 1952

Whedbee, T. Courtenay J *Interim Financing of Real Estate Mortgage Loans*. American Bankers Association, 1956

chapter XVI

LOANS ON ASSIGNED ACCOUNTS

IN THE LAST CHAPTER WE SAW WHAT WIDELY DIFFERENT TYPES OF collateral are used as security for short-term loans. Such loans are made against listed and unlisted securities, against foreign export bills, miscellaneous merchandise stored in bonded warehouses, warehouse receipts covering grain in terminal elevators, cotton, chattel mortgages, discounted notes receivable, and the cash surrender value of life insurance.

The proper handling of secured loans of these various kinds requires technical knowledge, experience, skill, and commercial intelligence. These transactions do not normally require the detailed policing and unusual attention demanded by accounts receivable financing.

Loans against assigned accounts, or accounts receivable loans, involve a more complicated technique than the other typical secured loans. They are nevertheless being used more and more by bankers in all parts of the country to extend credit to commercial and industrial business enterprises.

Primarily, this type of collateral is taken when working capital is inadequate to support the credit required on an unsecured basis. Such instances would be: (1) for highly seasonal operations, (2) for constant credit when the accounts assigned are few in number and large in amount and require a minimum of servicing, (3) for a temporary period until the retention of profits already in evidence increases working capital to a point where collateral is not required, and (4) to support the continuance of credit (formerly on an unsecured basis) in an effort to permit the company time to work out its financial problems.

Since accounts receivable financing has been used in many instances in a last effort to prevent an incipient insolvency many people concluded

that insolvency must inevitably follow this type of financing It has been increasingly used successfully, however, in a great many cases in comparison to each case in which insolvency may have followed No longer is the company that pledges its receivables considered to be just one step ahead of the sheriff The passing of the Assignment of Claims Act of 1940 which made possible the extensive use of the 'V' loan program under Regulation V [1] of the Federal Reserve System following World War II and the popularity of the "notice filing" type of statute, which has now been adopted in one form or another by many states, have dispelled the stigma once attached to accounts receivable financing

HISTORY

The widespread use of the open account, with provision for a discount for prompt payment arose in large part from an effort to minimize losses on fluctuating paper currency during the Civil War period The popularity of the open account was also connected with the subsequent development in the commercial banking world, of loaning on an unsecured basis. Prior to that most evolutionary period in our economic history, typical commercial loans of banks were made against notes as collateral These notes originated in two different manners as follows (1) as endorsed notes and trade acceptances arising out of actual business transactions, which a business enterprise discounted at its bank, and (2) as notes receivable created for the purpose of friendly accommodation

The first specialized finance company was organized in Chicago in 1905 Few competitors entered the field until between 1912 and 1915, when other concerns of this type were organized in Baltimore and New York City The growth of accounts receivable financing was more rapid after World War I Banks then began to be interested The need for working capital was accelerated by the depression following 1929 and by *the growing weight of corporate taxation since 1935 The short term* credit requirements of World War II materially accelerated the volume of loans on assigned accounts Larger inventories, threatened shortages, delayed government payments, and rising prices all put heavy pressure on working capital As a result, the volume of accounts receivable financing in both finance companies and banks expanded rapidly following World War II and continue to expand

[1] Under this facility the Army the Navy or the Maritime Commission would guaranty an agreed percentage of the loan in return for an agreed portion of the interest which increased with the percentage of the guaranty This regulation was eminently successful.

THE LAW AND ACCOUNTS RECEIVABLE

Prior to making any loan on accounts receivable or establishing a procedure for lending on the security of assigned accounts receivable, you should obviously consult your local attorney. The state laws relating to accounts receivable are not uniform. Currently there is a strong demand to establish the Uniform Commercial Code, designed to eliminate the conflict of laws. Presently there are the so-called "validation" states, the states that require public filing (the recording statutes), and the State of North Dakota which requires book-marking. In the validation states mere assignment is sufficient to convey title, and the first assignee of an account receivable is entitled to collect the proceeds thereof, regardless of notification. Among the filing states there are many different procedures which effect the perfecting of notice. Further, there is the question of conflict of laws when the borrower is located in one state and the account debtor in another.

The banker must be positive of the validity of the collateral. The prime essential in this connection is to make sure that the bank as a lender has complete and unfettered control and dominion over the accounts that are assigned to it. Under the decision of the United States Supreme Court in Benedict vs. Ratner,[2] which is generally followed, the finest forms in the world will be of no use to the bank if it permits the borrower to deal with the assigned accounts as if they were his own property. If he is permitted to do so and bankruptcy ensues, the bank's assigned accounts will probably be ruled to fall into the general assets for the benefit of all the general creditors.

Prior to 1938 there was sufficient confusion in the law, and in that year the situation was thrown into further confusion when Congress adopted the former Section 60a of the Chandler Act.[3] Following the Klauder decision, many states adopted statutes attempting to remedy the perfecting of the assignment. On March 18, 1950, an amendment to Section 60a of the Bankruptcy Act became effective which provides a remedy for the more undesirable features of the Klauder case.[4]

Clarification of what constitutes unfettered dominion and control by the assignee was spelled out specifically in a recent court case decided March 28, 1958. This involved The First National Bank of Chicago,

[2] 268 U.S. 353 (1925).
[3] Klauder vs. Exchange National Bank. 318 U.S. 434 (1943).
[4] Milton P. Kupfer, "Sick Sixty Cured," *The Business Lawyer,* V. No. 3 (May 1950), pp. 273.

defending an assignment of receivables due from The New Haven Clock and Watch Company, debtor, which filed a petition for reorganization under Chapter X of the Bankruptcy Act. 'Lack of dominion' by the bank was claimed by Arthur O Keefe, Jr., trustee, and the United States of America

The United States Court of Appeals (253 Fed 2d 577) stressed the following reasons for holding that the assignment was valid (a) the bank had appointed its own agent in the company to handle and forward all collections received in kind from the accounts assigned, (b) requiring the substitution of new accounts for those appearing doubtful of collection or for merchandise returned (c) requiring an agreed upon ratio of collateral to loans, and (d) the stamping of company's records to show the assignment.

Assignment of Claims Act

Some of the legal and practical obstacles that have hampered accounts receivable financing have been virtually eliminated Before 1940 accounts due from the Federal government and its departments could not be validly assigned In that year the Assignment of Claims Act[5] was passed permitting the assignment of monies due or to become due under a specified government contract when the procedure prescribed by the statute is followed This is a notification statute and requires that notices of the assignment be furnished to the contracting officer, the disbursing officer and any sureties upon bonds issued in connection with the contract The statute is applicable only to contracts that involve $1 000 or more and that contain no prohibition against assignments

The Uniform Commercial Code

This code is the joint product of the American Law Institute and the National Conference of Commissioners on Uniform State Laws The project was undertaken in 1941 by representatives of both organizations The Pennsylvania Legislature enacted the code in April 1953 to become effective July 1, 1954 Massachusetts adopted the code effective October 1, 1958, Kentucky, effective July 1, 1960, New Hampshire and Ohio, effective July 1, 1961, Connecticut, effective October 1, 1961, Arkansas New Mexico, Rhode Island and Wyoming, effective January 2, 1962, Illinois, effective July 1, 1962, Alaska, effective December 31, 1962, New

[5] 31 U.S.C. 203 41 U.S.C. 15

Jersey and Oklahoma, effective January 1, 1963; Georgia, effective April 1, 1963; Oregon, effective September 1, 1963; and New York, effective September 27, 1964. After six years of experience the Pennsylvania bankers reported the code[6] an improvement over the former law. After two years of experience Massachusetts bankers endorsed the Uniform Commercial Code. While it is not possible here to detail the application of the code to accounts receivable financing, the code is a modernization of the provisions of commercial law now scattered through seven major uniform acts and numerous statutes and case laws; its primary purpose is to simplify, clarify, and modernize the law governing commercial transactions and to provide uniform commercial laws throughout the country. Article 9 of the code[7] covering secured transactions, approaches the whole problem of the fundamental requirements for secured lending operations, including accounts receivable financing.

Advantages

Years ago nearly all merchandise sold on credit terms by wholesalers was paid for by notes and trade acceptances running for perhaps six or eight months. These promissory notes and trade acceptances were always on hand to be endorsed and discounted as a means of obtaining bank credit. If additional bank credit was needed before the notes and acceptances had been discounted, the owner of a business enterprise might exchange promissory notes with a friend, endorse the note he received, and discount it. Such a note is an accommodation paper. His friend did likewise. In those days a typical bank readily discounted both classes of paper.[8]

Today there are not many lines of business activity in which it is customary to settle trade obligations by note. The accommodation note is largely a thing of the past. The modern bank would take the special guaranty of a friend of one of its borrowers if the guaranty was sup-

[6] "After Six Years' Actual Experience We Like the Uniform Commercial Code," Pennsylvania Bankers Commercial Code Committee, 123 S. Broad Street, Philadelphia 9, Pennsylvania. It should be added that not all students of this subject are in agreement regarding the desirability of the Uniform Commercial Code.

[7] "The Uniform Commercial Code—Article 9," XLII, No. 6 (Feb. 1960); *Robert Morris Associates Bulletin*, XLII (Philadelphia, Pennsylvania) Homer Kripke, "The Modernization of Concepts Under Article 9 of the Uniform Commercial Code," *The Business Lawyer*, XV (April 1960) No. 3, p. 645.

[8] The points of view of writers on banking problems from 1810 to 1859 concerning the relative merits of advances made against accommodation paper, as compared with discounts of paper representing trade transactions, are summarized in Harry E. Miller, *Banking Theories in the United States Before 1860* (Cambridge: Harvard University Press, 1927), pp. 175–9.

ported by his financial statement Trade acceptances are still used in seasonal businesses where the manufacturer wants the retailer to take the goods out of season This relieves the manufacturer with respect to storage space and also permits him to have an obligation for discount

New Companies

It is quite obvious that only an established business can rely on unsecured borrowings A new business, lacking the history of a product of merit or of a stable earnings records, must offer security Outside of cash, the most liquid assets are accounts receivable and inventory Assuming that credit has been intelligently authorized, the accounts receivable are, of course the more liquid because the inventory has already been sold Not being able to get unsecured credit, the new enterprise will probably find it desirable to supplement working cash by borrowing on accounts receivable

Growth Companies

Accounts receivable financing is a quick source of obtaining cash until the borrower can be certain that his needs are for long term or equity financing On the other hand, accounts receivable financing may make it possible for the borrower to avoid unnecessary long term debt by providing the cash required until earnings can catch up following an expansion period, thus avoiding the sharing of ownership equity or control A company with a continuing growth may find it desirable to borrow on accounts receivable in increasing amounts over the years in order to avoid taking in a new partner or if a corporation, issuing more common stock

Other Advantages

There are a number of other advantages to the borrower in accounts receivable financing It permits the discounting or paying of bills promptly It permits frequent and quick expansion and contraction of a business. It permits seasonal businesses to level production It permits savings through large purchases, such as carload lots It permits a continuing source of operating cash, as contrasted to the annual liquidation required with an unsecured line of credit It provides the means for improving a credit rating

VARIOUS ASSIGNMENTS

On a Notification Basis

Jones and Company are manufacturers of specialized machinery. In an operation of their size, they have sufficient working capital to manufacture and ship only one machine costing $20,000. Having manufactured, sold, and shipped the machine, they must either shut their plant down until their customer, Roe & Company, pays them for it, or borrow money in some fashion to pay for the material and labor required to construct the next machine on order. While the management has a sound reputation for integrity and competence, their financial backing is not really adequate for any of the previously considered types of loan. They have sold their machine to a concern whose credit reputation is impeccable, and, in view of Jones' history of operations, the bank is confident that their product was soundly engineered and produced. In these circumstances the bank might well loan Jones and Company $15,000 until it is paid for its machine. This loan would be secured by an assignment of the account receivable from Roe & Company. The bank would then take, as evidence of this transaction, its standard form of demand note (Figure 95), together with a collateral agreement (Figures 97A and 97B) and an assignment of accounts receivable (Figure 98).

If it wanted to put this account receivable loan on a notification basis, the banker would write Roe & Company, furnishing them with a copy of the assignment and directing that the payment of the account be made to the bank.

On a Non-notification Basis

Most borrowers do not care to have their customers notified that they are pledging receivables in order to finance their operations. If Jones and Company felt this way and if the state law permitted, the bank might take its pledge of receivables on a non-notification basis. In this event it would not notify Roe & Company but would take the following additional steps:

1. The assignment might be more elaborate and would impose additional requirements on the borrower.

2. The bank would set up a collateral account under its complete control, into which all payments on assigned receivables would be deposited. If, for instance, Roe & Company paid cash to Jones and Company, the

latter would turn it over to the bank to be deposited into the collateral account If the monies were received in the form of checks, money orders, drafts or any other way, they would be brought to the bank in that form and the proceeds would be deposited into the collateral account The bank would take the borrower's own check only for repayment of return merchandise The identical checks received by the borrower from its debtors prove the accounts assigned were not fraudulent and were in fact bona fide The collateral department should examine all such checks deposited in the collateral account Any personal money orders cashier's checks, or the borrower's own checks require an explanation

3 The original ledger sheet of Jones and Company containing this account would be stamped with a legend stating that this account has been assigned to the bank

4 The bank would take two duplicate copies of the invoices stamped with a specific assignment (see form of assignment on page 408)

This in essence is the way accounts receivable financing is handled on a non notification basis

Blanket Assignments

This transaction with Jones and Company is a simple one However, as a manufacturer, Jones and Company will be selling to many different purchasers It may be that instead of having a long list of selected names for assignment and having to segregate the remittances on the selected accounts as received by Jones and Company for deposit to the collateral account it would be preferable to have a blanket assignment This would assign to the bank *all* of the receivables of Jones and Company, and *all* remittances would be deposited in the collateral account. In this type of operation the margin required would normally be greater to allow for past due accounts trade discounts and regular discounts The entire balance due from each customer must be considered rather than the individual past due invoices when figuring the collateral margin because of the amount of paper effected by the delinquent invoices Under this system, on the first day of operations the bank would take an assignment listing all names and amounts individually Assuming the accounts assigned have an aggregate face value of $10 000 and the loan is made on a 75 per cent basis, it would then credit the borrower's checking account with $7 500 Each day copies of the invoices for the new shipments would be batched, sent to the bank, and the total amount would be added to the

collateral pledged. A special form of assignment, which must accompany the new invoices, instead of only a list of names and amounts, would be put on the schedule in Figure 99 on page 406. To this form of assignment the following might be added:

Form for Daily Assignment of Invoices When Using Blanket Assignment.
All accounts receivable presently owing to us from our customers designated in the attached copies of invoices, including all sums owing on these or earlier invoices. We certify that all merchandise shown in each attached invoice copy has been actually delivered or shipped to the customer.

Actually the invoices for several days' production might be brought in at the time of a new borrowing. This would be preferable, so that new money would be advanced as consideration for the additional accounts assigned. As payments are received on the account, they are deposited into the collateral account. Assume that before any additional borrowings occur in this transaction, $2,000 is paid on the accounts and deposited into the collateral account. It is usual about once a week to apply the proceeds in the collateral account to the note to reduce the obligation. This gives the bank an opportunity to collect the checks and thus to have funds to apply against the borrowing. Assuming that all the checks are cleared properly and application of the proceeds therefrom have been used to reduce the note of Jones and Company, the bank loan is now reduced to $5,500 secured by accounts aggregating $8,000. On the basis of loaning 75 per cent of the face value of the accounts receivable, now held by the bank, the company can borrow a total of $6,000. This means that there is $500 excess borrowing power, which the customer can acquire by simply signing another note. In the meantime, of course, with the additional shipments and the additional assignments, undoubtedly the collateral itself has increased. Usually at the end of specific periods, perhaps every thirty days or quarterly, the borrower will provide a classification of the receivables according to their age so that the desirability or value of the collateral can be reviewed.

Some banking institutions, wishing to avoid the continued issuance of new notes, release funds directly from the collateral account to the borrower in exchange for new collateral. Numerous variations can be conceded, but the financing institution must at all times be positive that there is consideration for the pledge of additional collateral and that it has dominion over the funds.

So far we have outlined the procedure for policing collateral at the financing institution to "insure dominion." Risks inherent in taking this

type of collateral require a representative of the bank to visit the borrower's premises further to insure the "goodness of the collateral" During such investigations the duplicate assigned invoices are checked against the ledger records to verify that they continue unpaid, that all payments and credits for returns and allowances have been reported, and that the ledger sheets are stamped to show the assignment The bank representative also checks shipping documents against the unpaid assigned invoices checks handling of merchandise returned ages the accounts examines correspondence on delinquencies and discusses them with the credit manager, comparing such accounts with the high credit shown on the ledger cards during the past year and noting the dates and amounts of the last payments

Loans to Contractors

Financing institutions must be especially alert when making loans to contractors. Contractors are described as building contractors, road contractors, or any contractor from whom a performance or completion bond is required Invariably the bonding company, by virtue of its application for the bond or by case law, will have a prior lien against the receivables unless there is a consent to the loan by the bonding company Such consent is seldom forthcoming

Factoring vs Accounts Receivable Financing

In factoring the manufacturer sells his accounts receivable to a factor for cash and at 100 per cent of face value The factor actually buys the accounts outright He assumes all risks himself He takes over the entire job of billing and collecting He is protected by the fact that he has previously approved the credit of the names of the accounts receivable that he will purchase The manufacturer may have no liability In exchange for this, he pays an interest charge and in addition, he pays a fee for the risk and the services of collection, usually a percentage of the volume of sales. This fee usually ranges between 1 and 1½ per cent.

In the case of accounts receivable financing, the manufacturer is fully liable and simply pledges the receivables as collateral to his liability getting in return an advance of generally 75 or 80 per cent of the total receivables. The manufacturer takes the full risk on the credits he has approved

The factor sends out the invoices stamped to remit to the factor. In accounts receivable financing, the financial institution and the manufacturer treat the arrangement as strictly confidential. The customers are not notified of it, unless the financing is on a notification basis, which is seldom the case.

MECHANICS OF MAKING LOANS ON ASSIGNED ACCOUNTS

Loans of this nature are generally made at a rate substantially in excess of the going rate on other types of loan. In certain instances additional service charges, ranging up to 3 per cent, are added, depending upon the size of the loan and particularly upon the number and size of the accounts to be handled. Some banks keep a cost record of any extra expense arising from the detailed work of handling such loans. Charges are not uniform and are determined for the individual case. Most loans, however, carry no service charge. Counsel for some banks advise against any service charges, feeling that the total cost to the borrower may exceed the usury statute of the state. Bank rates are less than the rates normally charged by factors and specialized finance companies, but are considerably higher than the rates that commercial banks in large cities charge for the other desirable types of loan.

Prior to concluding an arrangement for a loan on accounts receivable, most banks will make a credit investigation of the borrower to determine: (1) that bookkeeping practices are adequate and proper, (2) that postings are up to date, (3) that collection effort is reasonably efficient, (4) past bad debt experience, if any, (5) the credit responsibility and paying record of the people to whom credit is granted, (6) what terms are granted and whether they are conservative or too liberal, (7) whether there are any shipments on consignment, (8) whether there are contra accounts or advances from customers, (9) if there are affiliated company accounts, (10) the average size of invoices, (11) the quality of the product and the relative percentage of returned merchandise, (12) that purchase orders have no prohibition of assignment or other undesirable terms, and (13) whether discounts are taken or accounts are paid promptly. A complete classification of the age of the accounts payable is desirable.

In this type of financing, detailed certified audits should be procured once annually. Aside from this, the bank will determine how frequently it wants interim financial statements.

In setting up the line of credit, the bank management will want to be

sure that it is establishing sufficient borrowing capacity to take care of the borrower's requirements

It is important to bear in mind that an account not having an actual—or, in some states, potential—existence may not be validly assigned in some states. The underlying theory is that no one can pledge anything that does not at the moment exist and that may never exist The actual existence of an account may be reasonably ascertained to a certain degree by having the agent or accountant of the bank spot-check the accounts and examine the delivery tickets on them Whether accounts have a sufficient potential existence—that is, they are legally contracted to come into existence—is an extremely technical question dependent on local law It is recommended that the bank s attorney be consulted before such accounts are accepted

Determine What Is Available for Security

In financing claims arising under written contracts whether with the Government or with any other purchaser careful study should be given to the provisions of the contract providing for payment in order to determine what is really available for security An assignment of a claim under a $100 000 contract certainly has no collateral value until there has been some consideration—that is, until the delivery of the item or items that oblige the purchaser to pay It was the difficulty of financing terrifically expanded production that gave rise to the need for the 'V' loan guaranty program by the Army the Navy and the Maritime Commission during World War II A concern would receive a contract for war material in an amount far exceeding its capacity to finance from its regular working capital It needed money to buy material and pay workmen before it could create and deliver the items called for by the contract The contract itself had no collateral value until the items were manufactured and delivered To bridge this gap, the 'V' loan program was evolved, and, as previously noted the Army, the Navy, or the Maritime Commission would guarantee an agreed percentage of the loan in return for an agreed portion of the interest which increased with the percentage of the guaranty The program was quite successful

The financing institution must also be alert to avoid taking an assignment of orders It is only after a shipment that an account receivable comes into being There is no value in an order as such for collateral purposes Further, the purchase order forms of a number of large companies have a prohibition against assignment of the receivable arising out of

the order. In this event it will be necessary to get the consent of the purchaser in order to have an enforceable assignment.

Written Request for the Loan

Most banks do not require a written request for the loan. However, many bankers insist that a request for a loan on assigned accounts be made by letter and not verbally. A draft of such a letter is prepared by the banker and given to the prospective borrower, who then copies it on his own letterhead, signs it officially, and turns it over to the loaning officer. Such a letter follows:

_______________, 19__

Reliable National Bank
Minneapolis, Minnesota
Gentlemen:

The undersigned hereby applies to you for a loan of $______ to be evidenced by the promissory note of the undersigned, payable ____________, with interest at the rate of __% per annum, payable monthly, and to be secured by the annexed assignment of accounts receivable due to the undersigned.

The proceeds of this loan are to be used in the ordinary course of business, and not to purchase or carry securities listed on a national exchange.

Yours very truly,

____
(Signature of borrower)

Approved _______________________
(Name of bank here)
By _______________________
(Title of Officer)

The following is a typical, somewhat longer form:

_______________, 19__

Reliable National Bank
Minneapolis, Minnesota
Gentlemen:

We have today assigned to your bank as collateral security certain of our Accounts Receivable. In connection with these Accounts Receivable, we have prepared statements showing the balance due us as of today from each customer. These statements are prepared as a method of physically evidencing the existence of the Accounts Receivable, and we have caused each of these statements to be assigned on its face to your Bank, the signature of the said Assignment in each instance being made by a duly authorized officer of this corporation.

These statements we have today delivered to you to indicate a full and

complete appropriation of said Accounts to your Bank and we hereby certify that your Bank now has and will hereafter be entitled to maintain unfettered dominion over said Accounts Receivable and each of them, and any additions thereto and substitutions therefore together with the proceeds thereof

It is understood that your Bank shall at no time be under any duty to collect said Accounts Receivable so assigned to your Bank or hereafter assigned to your Bank unless you elect to do so and you shall not be liable to this company except for willful misconduct in respect of the collections of the said Accounts Receivable

Yours truly,

Special Agent

Most small and medium-sized banks as well as some large banks do not require the appointment of a special agent. On the other hand, where there may be a sizable line of credit, arrangements are made for the appointment of an individual as special agent of the bank This individual is ordinarily an employee of the borrower He is not an officer of the concern The bank and the borrower arrive at a mutual understanding as to who this individual should be The following form covers the technical procedure for making such an appointment

DESIGNATION OF SPECIAL AGENT WITH RESPECT TO ASSIGNED ACCOUNTS RECEIVABLE

The undersigned RELIABLE NATIONAL BANK Minneapolis, Minnesota assignee of accounts receivable under assignment from

____

as assignor does hereby designate ____________________ as its special agent with the following authority

To receive the proceeds of all accounts receivable now or hereafter assigned whether said proceeds are in the form of currency checks or other instruments of indebtedness, and to transmit said proceeds to this bank as soon after collection or receipt thereof as possible Delivery of these proceeds to the bank may be accomplished through either one of the following methods designated by the undersigned

1 Through handing to one of the note tellers of the bank taking his receipt therefor or seeing that the amount is immediately endorsed upon the note of the above mentioned assignor

2 Through depositing said proceeds in an account designated ____________ ____________________, Collateral Account said account having been opened by the Reliable National Bank for convenience in handling said proceeds and being subject to the bank s order only

It is further understood that in the event it shall in the future become necessary to allow credits to debtors upon any assigned accounts covered by this assignment on account of merchandise returned or inferior or damaged mer

chandise, or for any other reason, or to make any adjustment of a credit owing by a debtor upon any account herein assigned, said allowance of credit or adjustment of said account may be made by the agent herein designated, but solely as agent of the assignee bank; and no such allowance of credit or adjustment of account shall be valid unless first submitted to and approved in writing by said assignee bank. Any merchandise or goods representing any part of any account hereby assigned, which are returned, shall be set apart and plainly labeled as being pledged to this Bank. No such returned merchandise shall be resold without the prior written consent of this Bank, and when resold the proceeds of such resale or any account representing the same shall be immediately delivered to, or assigned to (as the case may be) this Bank.

It is understood that the special agent hereinabove designated shall have no authority as the agent of the undersigned to do any act not herein expressly set forth. It is intended that this instrument shall survive the full payment from time to time of loans secured by the assignment of accounts receivable to Reliable National Bank, and that the same shall be operative until express written notice of modification or revocation thereof is given to the special agent by Reliable National Bank in person or by mailing a copy thereof through the United States mails, postage prepaid, to the agent's last known business address.

Dated at Minneapolis, Minnesota, this ____________

RELIABLE NATIONAL BANK
By ____________________

Accepted:

____
Special Agent

A form generally used for the handling of returned merchandise follows:

Reliable National Bank
Minneapolis, Minnesota
Gentlemen:

I desire to advise you that ____________ the debtor named in an account assigned you by ____________ Invoice No. ____ requests a credit allowance upon said account in the sum of $____ by reason of ____________________ which allowance the above assignor believes should be granted.

As your special agent in the collection of this account, I recommend an allowance credit in the sum of $____ upon this account, leaving a balance due of $____. I desire your directions.

Very truly yours,

____
Special Agent

This particular instrument might range from one to five or more closely typed or printed pages. The example of a loan agreement in Figure 105 at the end of this chapter is unusually complete and seems to cover every possible contingency, as well as the rights and privileges of each party. A shorter form appears in Figure 98.

Figure 94 Typical General Resolution

Corporation

CERTIFIED COPY OF RESOLUTION

____________________, 19____

We certify to ____________________ that the board of directors of ____________________

____________________, a corporation organized under the laws of the State of ____________________, at a meeting regularly held on ____________________, 19____ adopted a resolution, which has been recorded in the official minutes of the meeting A true copy of the recorded resolution is shown below It is still in force and not contrary to, or inconsistent with, any provision of the corporation's articles of incorporation or by laws

RESOLVED, that ____________________ is approved as a depository of funds of this corporation The representatives of this corporation who are authorized to transact its business with the bank are the persons who from time to time hold the following offices or positions in this corporation president vice president, secretary or treasurer ____________________

____________________.

Each of them may so act alone except as otherwise provided in this resolution They may open accounts, make deposits and withdrawals, endorse checks and other instruments payable to this corporation and sign checks issued by this corporation All checks so issued shall be signed by any __________ of them

Any check or other instrument that is endorsed or signed in accordance with this resolution may be paid cashed or accepted for deposit in any account by the bank without its questioning or being responsible for, any personal or unauthorized use of the instrument or its proceeds by any of the authorized representatives

FURTHER RESOLVED, that the same authorized representatives, acting on behalf of this corporation may borrow money from the bank and sign promissory notes for the loans in any amounts and on any terms They may discount, sell, accept and request collection of any negotiable or other instruments and contracts. They may pledge, mortgage and assign any assets of this corporation including real estate as security for payment of its obligations to the bank With respect to any borrowing discounting or other business with the bank, they may make and sign any endorsements guaranties collateral agreements and other agreements All promissory notes for loans by the bank shall be signed by any __________ of them

____

____

The bank may rely on certificates by the president or secretary as to the names, titles and signatures of the persons who now or in the future are the authorized representatives designated by this resolution The authority of every person who is so certified may be regarded by the bank as continuing under this resolution until it receives written notice that he has ceased to hold his office or position or that this resolution is no longer in force

____
Secretary

(CORPORATE SEAL)

Signature of another officer or a director ____________________

Title ____________________

NOTE—The paragraph beginning "FURTHER RESOLVED" may be omitted from the resolution which is adopted at the directors meeting if the corporation will simply carry a checking account but not borrow money or transact other business with the bank. If this paragraph is omitted from the adopted resolution it should of course be cancelled in the above certified copy

Figure 95 Demand Note Form

Minneapolis, Minn.________________19___ | $__________

__________after date for value received the undersigned promises to pay to the order of RELIABLE NATIONAL BANK MINNEAPOLIS

____Dollars

with interest at the rate of__________per cent per annum until paid

Payable at RELIABLE NATIONAL BANK MINNEAPOLIS Presentment for payment protest and notice of dishonor are waived by each maker endorser and guarantor hereof

No.__________

____

____

Address________________ ______________________

Due__________

Figure 96 Collateral Note Form

Minneapolis, Minn.________________19___ | $__________

__________after date for value received the undersigned promises to pay to the order of

RELIABLE NATIONAL BANK MINNEAPOLIS

hereinafter referred to as the Bank, at its banking offices in Minneapolis, Minnesota, the sum of

____Dollars

with interest at the rate of__________per cent per annum until paid. Presentment for payment, protest and notice of dishonor are waived by each maker, indorser and guarantor hereof.

All securities, documents, rights and property owned or pledged by any signer of this note that now or at any time or times hereafter while this note remains unpaid may be pledged, delivered or assigned to the Bank or for any reason or purpose whatever be in the hands, possession or name of the Bank, are hereinafter referred to as the collateral. All such collateral shall be held by the Bank as security for payment of this note and as security for all other direct or contingent indebtedness or liability to the Bank of any signer of this note, whenever created, incurred, existing or due.

No.__________

Due__________

With respect to each and every item of the collateral, the Bank is authorized to collect all payments due on account thereof with or without legal action to cause any stock or security to be registered in its own name as pledgee or otherwise to indorse or assign, in the name of any signer hereof or of itself, the item or any instrument of payment on account thereof and to extend, renew exchange or compromise the item or return it to any signer hereof provided, however that the Bank shall have no duty to do any such thing or to give any notice to, or in any manner proceed against, any maker indorser or surety The undersigned will pay to the Bank the amount of all reasonable expenses paid or incurred by it in connection with preserving or collecting the collateral.

This note and all other obligations secured by the collateral shall at the option of the Bank and without notice to anybody become forthwith due and payable upon the occurrence, with respect to any signer hereof, of any of the conditions or events following (a) failure in business, insolvency receivership, liquidation, bankruptcy or reorganization of the signer (b) entry of any judgment against the signer (c) garnishment of the Bank in any proceeding in which the signer is named as a defendant (d) death of the signer; (e) failure by the signer upon demand, if the collateral depreciates in value, to reduce the unpaid amount of this note or pledge additional collateral as may be required by the Bank.

Upon default in payment of this or of any other obligation secured by the collateral when due, whether due expressly or at the Bank's option as provided above, the Bank may forthwith or later sell any or all of the collateral, including any collateral in the form of negotiable or commercial paper The sale or sales may be private, at broker's board or at public auction. If at broker's board or public auction, the Bank may itself be a purchaser free from any right or equity or redemption by any signer hereof. The proceeds of sale shall be applied, first, in payment of all expenses in connection with sale, including attorney's fees, and second, in payment upon the principal and interest due on this note and on any other obligations secured by the collateral, any deficiency to be paid by the undersigned and any surplus to be paid to the undersigned or to any of them.

This note shall bind each signer hereof whether or not it is also signed by others.

Interest on this note from date to maturity has been paid.

____

Address________________ ______________________

The fifth instrument, which lists the accounts pledged, is sometimes printed on the reverse side of a single-page form of assignment. It may, however, be a separate form, showing the name of each debtor, the amount of the invoice, the date each account is payable, and, at times,

Figure 97A General Form of Collateral Agreement (*front*)

COLLATERAL AGREEMENT
with
RELIABLE NATIONAL BANK

The undersigned, in consideration of financial accommodations by the Bank, agrees with the Bank as follows:

1. All collateral of the undersigned shall be held by the Bank as security for all obligations of the undersigned to the Bank. Throughout this agreement "collateral" means everything which the undersigned owns or has authority to pledge and which now or at any later time or times is pledged, assigned, transferred or delivered to the Bank or is by any means or for any purpose in the possession or name of the Bank or of another as agent or bailee for the Bank. This includes stocks, bonds, securities, negotiable instruments, money, chattels, contracts, claims, choses in action, judgments and documents of all kinds. Throughout this agreement "obligations" means all direct and contingent indebtedness and liability of the undersigned to the Bank whenever created, incurred, existing or due. This includes all present and future indebtedness or liability of the undersigned (whether as principal or surety or as maker, acceptor, endorser, guarantor or other signer) on or for any loan, note, bill of exchange, overdraft, this agreement, another contract, any money paid for the use or account of the undersigned or any other act, matter or thing. It also includes indebtedness owing to the Bank as trustee, indebtedness owing both to the Bank and to another or others and indebtedness owing to the Bank in which a share or participating interest is owned by another or others.

2. The Bank shall have a lien upon all balances in any checking, savings, deposit or other account of the undersigned with the Bank, including any joint or other account in the names of the undersigned and another or others, as security for all obligations of the undersigned and it may charge, apply or offset any such balance against any such obligation that for any reason may be or become due.

3. With respect to the collateral the Bank is authorized at its option and in its own name or the name of the undersigned (a) to demand and receive all payments due on account thereof, (b) to maintain any action, suit, foreclosure or other proceeding which it deems advisable to enforce or collect any such payment, (c) to cause any stock or security to be registered in its own name as pledgee or otherwise, (d) to do whatever it deems advisable in order to acquire possession of or prevent loss with respect to any goods evidenced by any shipping or storage document or receipt, (e) to endorse or execute an assignment of any item of collateral or any check, draft or other instrument received as a payment on account thereof, and (f) to extend, renew or compromise any such item or payment. However, it is understood that the Bank will have no duty to exercise any of the powers hereby granted or under any circumstances to notify or proceed against any maker, endorser or surety or in any manner to act to preserve or enforce any liability.

4. The undersigned will pay to the Bank the amount of all reasonable expenses, including attorney's fees, paid or incurred by the Bank in connection with preserving, renewing, securing, collecting or enforcing the collateral or any obligation of the undersigned.

5. Notwithstanding any maturity or due date stated in any existing or future note or other instrument, all obligations of the undersigned shall, at the option of the Bank and without notice or demand to anybody, become forthwith due and payable upon the occurrence of any of the conditions or events following: (a) the failure in business or insolvency of the undersigned however evidenced, (b) the filing of a petition by or against the undersigned in bankruptcy or for reorganization or relief under the bankruptcy laws, (c) a general assignment by the undersigned for benefit of creditors, (d) the appointment of a receiver, trustee for creditors or other liquidator of any property of the undersigned, (e) the entry

the number of each invoice This is the detailed record of the security for the loan and is of the utmost importance This schedule appears in Figure 99 and is usually printed on the reverse side of the assignment of accounts receivable in Figure 98

Figure 97B General Form of Collateral Agreement (*reverse*)

of any judgment against the undersigned, (f) service on the Bank of a garnishee summons or notice of attachment or levy in any action or proceeding in which the undersigned is named as a party (g) the death of the undersigned, (h) the discovery by the Bank of any misrepresentation by the undersigned or by any officer or agent of the undersigned, which pertains to the financial condition or responsibility of the undersigned, (i) failure by the undersigned upon demand, in the event of depreciation in value of the collateral to reduce the obligations of the undersigned or pledge additional collateral as reasonably requested by the Bank, or (j) any default in payment when due of any principal or interest of any obligation of the undersigned.

6 Upon failure by the undersigned to pay any obligation when due whether due at the Bank's option or otherwise the Bank is irrevocably authorized but not required, to sell, forthwith or at any later time or times, any or all of the collateral, including any negotiable instruments commercial paper and choses in action. Such sale or sales may be made privately at broker's board, at public auction or in any other manner and without any previous demand for payment or any notice of the sale to the undersigned or any other person. If any such sale be at broker's board, stock or commodity exchange or public auction the Bank may itself be a purchaser at the sale and shall hold everything so purchased free from any right or equity of redemption of the undersigned The proceeds of sale shall be applied, first in payment of all costs of sale and all expenses, including attorney's fees, that may be paid or incurred by the Bank in connection with the sale or preparing for sale or preserving or attempting to enforce the collateral before sale and second in payment upon the obligations of the undersigned to the Bank in such order as the Bank may elect If any part of the principal or interest of such obligations remains unpaid thereafter the undersigned shall remain liable therefor If any surplus of the proceeds remains after full payment of the obligations it shall be held subject to the order of the undersigned.

7 If any note or other instrument evidencing an obligation of the undersigned is transferred by the Bank by sale discount or pledge all or any part of the collateral may be delivered to the transferee as separate security for the transferred obligation without impairing the rights of the Bank in any obligation or collateral retained by it Delivery by the Bank to the transferee of this agreement or a copy thereof shall operate as an assignment of all rights hereunder with respect to the obligation and collateral so transferred and delivered, with the same effect as if an agreement in the form hereof substituting the name of the transferee for the name of the Bank were then signed and delivered by the undersigned for a consideration to the transferee.

8 This is a continuing agreement applicable both to present and future transactions and relations between the undersigned and the Bank. It shall bind any executors, administrators successors and assigns of the undersigned and shall benefit and be enforceable by any successors and assigns of the Bank. The rights hereby granted to the Bank are in addition to and not in lieu of all other rights which it may have at any time by reason of any other instrument or act

Signed, and A COPY HEREOF RECEIVED ______________________ 19____

____

____

(If a corporation, affix seal)

The collateral department, in keeping careful records, might use the form in Figure 100 when computing the summary of current collateral and the loan value preparatory to another advance.

The sixth instrument is the remittance sheet, Figure 101. This is also at times a specially printed form and at other times merely a record on a blank sheet of paper. Here the borrower gives the name or the number of the accounts for which checks are received in payment each day, the

Figure 98 Short Form of Assignment of Accounts Receivable

ASSIGNMENT OF ACCOUNTS RECEIVABLE, CONTRACTS AND INVOICES

KNOW ALL MEN BY THESE PRESENTS—

That the undersigned, in consideration of financial accommodations given, or to be given, or continued to or furnished the undersigned by

Reliable National Bank, Minneapolis, Minnesota

(hereinafter called the "Bank"), and as collateral security for the payment of any and all indebtedness obligation or liability of any kind whatsoever, now or hereafter owing from the undersigned to the Bank (hereinafter called "indebtedness"), whether such indebtedness be direct or contingent, due or to become due, now existing or hereafter contracted, and wherever payable and including such as may arise from endorsements, guaranties, acceptances, drafts, overdrafts, discounts or in any other manner whatsoever or upon notes or other evidences of indebtedness issued, endorsed, guaranteed or negotiated by the undersigned to other persons and acquired or purchased in any manner and held by the Bank and the interest on all such indebtedness and expenses, if any, which may be incurred by the Bank in connection therewith, does hereby sell, assign, transfer and set over and pledge unto the Bank all the right, title and interest of the undersigned in and to all sums now or hereafter due and owing to the undersigned on all those certain accounts receivable, contracts and invoices described in the schedule on the reverse side hereof, or in the schedule hereto attached, and all future additions to all said accounts receivable, contracts and invoices together also with all additional amounts, if any, payable under any contracts, purchase orders or invoices which are amendatory, supplemental or in addition to the contracts, purchase orders or invoices above described, and does hereby fully authorize and empower the said Bank, its agents or attorneys, at its or their own election but without any duty or liability so to do, to demand and receive payment of said sums or any part thereof and to commence, maintain or discontinue any action, suit or other proceeding which it or they deem advisable to collect or enforce payment of any thereof, to compromise, compound and settle any thereof, to endorse the name of the undersigned on checks, drafts or other instruments tendered or received for payment of said sums, to repossess goods, wares and merchandise sold for which said sums are owing, and to resell the same on such terms and for such prices as it deems advisable, and to do any and all other things which it or they in its or their discretion deem necessary or advisable

The undersigned does hereby agree that if, in the course of its business, payments are made to it in payment of or to apply on said accounts, contracts or invoices, that it will forthwith, upon receipt thereof, endorse, transmit and deliver to the Bank any and all checks drafts cash or other remittances which may be received by the undersigned and the undersigned agrees that it will not commingle any of such money or other remittances with any of its own funds or property but will hold the same separate and apart from its own funds and in trust for the Bank until delivery thereof is made to the Bank.

The undersigned further agrees as to those accounts receivable, contracts and invoices which heretofore have been and still are assigned to the Bank and which are also included in the schedule above referred to, that this assignment is intended to be a reassignment thereof and an assignment of all additions thereto

The undersigned further agrees that, immediately upon the execution hereof, it will record on all of its books and records pertaining to said accounts, contracts or invoices a notation clearly setting forth that the same have been assigned to the Bank, or it will permit the Bank to record such notation

This assignment shall be binding upon the undersigned its successors and assigns

IN WITNESS WHEREOF, the undersigned has caused this instrument to be executed this

day of , 19

old balance, allowances if any, cash paid, total credit to the account, and the new balance, if not paid in full This is a very important form in handling property loans on assigned accounts

Four other useful forms are resolution for facsimile signature, resolu-

Figure 99 Form for Schedule of Accounts Receivable

SCHEDULE

OF ACCOUNTS RECE VABLE, CONTRACTS AND INVOICES ASS GNED TO

Rel able National Bank, Minneapolis Minnesota

BALANCES AS OF____________________

✓	CUSTOMER NAME	CUSTOMER ADDRESS	CREDIT RATING	DATE OF OLDEST CHARGE	PRESENT UNPAID BALANCE	PAYMENTS
				TOTAL		

tion for additional pledgor, used to obviate the necessity of having executives manually sign all invoices; form of waiver required when purchase orders restrict assignment; and loan agreement used in connection with assigned accounts receivable. These forms are illustrated in Figures 102–105 at the end of this chapter.

Figure 100 Form for Summary of Collateral and Loans

SUMMARY OF COLLATERAL AND LOANS

BORROWER ____________________ DATE ____________

SUMMARY OF COLLATERAL				SUMMARY OF LOANS	
PRESENT COLLATERAL	AMOUNT	%	LOAN VALUE	PRESENT LOAN	
NEW COLLATERAL				NEW LOAN	
TOTAL COLLATERAL				TOTAL LOANS	
INSTRUCTIONS				APPROVAL OF OFFICER	COLLATERAL DEPARTMENT

Figure 101 Form of Remittance Sheet

TO—
RELIABLE NATIONAL BANK
Minneapolis, Minnesota

FROM ____________________
(Name of Borrower)

Date ____________________

We enclose herewith original checks received by us in settlement of Accounts Receivable heretofore assigned to you

Name of Account or Number	Old Balance	Discount	Allowance or Returned Merchandise	Cash Paid	Total Credited to Account	New Balance	

Total amount of accounts assigned as per your books.

LOANS ON ASSIGNED ACCOUNTS

Stamping Invoices on Non notification Basis

As we have observed, the great majority of these loans are made on the non notification basis The borrower stamps on the two copies of each invoice that is pledged, an assignment that reads somewhat as follows

Minneapolis, ____________, 19__

For value received, the within account is assigned and transferred by the undersigned to RELIABLE NATIONAL BANK, Minneapolis, Minnesota, and said bank is irrevocably authorized and empowered, in its name or in the undersigned's name or otherwise, to demand, collect, sue for, and receive the same and to endorse, negotiate, or assign checks and other instruments tendered or received in full or partial payment or compromise thereof, with full power of substitution and revocation

THE DEBTOR OWING THIS ACCOUNT IS HEREBY DIRECTED WITHOUT OTHER OR FURTHER INQUIRY TO PAY THE AMOUNT THEREOF TO SAID BANK AND THE RECEIPT OF THE BANK SHALL BE A FULL AND COMPLETE RECEIPT AND ACQUITTANCE FOR MONIES SO PAID

______________________________(SEAL)

The original and one duplicate of each invoice so stamped are delivered to the bank Should the borrower go into bankruptcy, the duplicate in voice is mailed by the bank directly to the account involved The rubber stamp is signed by an authorized officer if the borrower is a corporation, by a partner in the case of a partnership, and by the owner in the case of a proprietorship

Stamping Ledger Pages

As the items on the sheet are pledged, a stamp reading, "This account is pledged to the Reliable National Bank," is placed at the top of the page It is highly desirable to have all items due from any one customer pledged If for some particular reason only certain items on the ledger sheet have been pledged, the words "Reliable National Bank" are stamped beside those items, and the word "Pledged" is stamped at the top of the page

Checks Deposited Daily

As checks come in to repay accounts, the borrower separates those that are to pay pledged accounts, endorses them, and lists them on the remittance form shown in Figure 101 The original checks are attached to this form and are either paid to the bank for credit upon the loan or deposited

in a special collateral account, against which checks may be drawn only with the consent of the bank. As amounts accumulate in the collateral account in excess of the required collateral, including outstanding assigned accounts, such excess funds may be released to the borrower.

Where the loans are made on a non-notification basis, no special endorsement appears on the checks to indicate to the maker that the receivables were pledged. Advances usually are made up to 75 or 80 per cent of the aggregate face amount of the receivables, the 20 or 25 per cent acting as a reserve and also providing some allowance for discounts, freight charges, or trade disputes. By this process the customer is given a certain amount of flexibility in adjusting his receivables, despite the fact that they may be pledged. The banker invariably examines the quality of the accounts to be pledged beforehand and selects or admits only those that represent well-rated names. If names of poorer quality are admitted, the advances might be reduced from 80 per cent to as low as 50 per cent. Where an account runs slow, the banker generally insists that another one be substituted.

Borrowing on a Notification Basis

Where the loan is granted against assigned accounts on a notification basis, the invoice sent to the buyer by the seller bears a stamp reading as follows:

For value received this account is transferred to the Reliable National Bank of Minneapolis, Minnesota. Please make remittance direct to them when due.

A duplicate copy of the invoice is sent to the bank at the very same time. Under this arrangement the buyer of the merchandise knows that his account has been assigned to a third party to secure a loan and that he must remit to that third party when his account becomes due. Outside of these two changes and the fact that no remittance sheet is needed, the procedure is similar to that followed on the non-notification basis.

Experienced commercial bankers feel that a borrower who cannot be trusted to carry out an agreement on a non-notification basis is not entitled to credit on any basis. Outside of the textile industry, loans on a notification basis are the exception. In addition to the moral responsibility of those borrowing on the non-notification basis, the bank is additionally protected, legally and practically, by the means taken to ascertain that pledged items are properly recorded on the books of the borrower and that the checks received in payment of such accounts are promptly deposited by the seller of the merchandise.

Figure 102 Resolution for Facsimile Signature

I Secretary of

a corporation organized and existing under the laws of the State of

DO HEREBY CERTIFY that a meeting of the Board of Directors of said corporation held on the at which a quorum was present and acting throughout the following resolutions were adopted and are now in full force and effect.

WHEREAS this corporation has established general banking relations with The First National Bank of Chicago including the borrowing of funds and pledging of security for the repayment thereof and

WHEREAS there will be included from time to time in collateral pledged by this corporation with said bank assignments of accounts receivable of this corporation and

WHEREAS for the convenience of this corporation it has requested The First National Bank of Chicago to accept the facsimile signature of and of this corporation on assignments of any accounts receivable which are acceptable collateral to said bank in addition to such manual signature or signatures if any by persons heretofore or hereafter authorized to assign receivables in behalf of this corporation and

WHEREAS The First National Bank of Chicago has indicated it is unwilling to comply with the foregoing request unless this corporation passes a resolution of its Board of Directors expressly authorizing the assigning of accounts receivable upon the facsimile signature of and and relieving said bank from any duty to ascertain by whom such facsimile signature was affixed

NOW THEREFORE BE IT RESOLVED that and of this corporation are hereby authorized to assign any and all accounts receivable of this corporation now existing or hereafter created to The First National Bank of Chicago upon their facsimile signature

BE IT FURTHER RESOLVED that any accounts receivable of this corporation assigned to The First National Bank of Chicago as collateral security bearing or purporting to bear the facsimile signature of and shall give said bank a good and valid first and prior lien on said accounts receivable to the same extent as if the same bore the manual signature of said and and there shall be no duty on the part of said bank to ascertain the genuineness of such facsimile signature or by whom the same was affixed to any such assignment.

BE IT FURTHER RESOLVED that the facsimile signature of and hereinafter appearing below the corporate seal of this corporation is the true and genuine facsimile signature of the said and

BE IT FURTHER RESOLVED that the foregoing resolutions are in addition to and not in contravention of any prior resolutions of this corporation or any subsequent resolutions relating to this corporation's banking transactions with said bank.

BE IT FURTHER RESOLVED that these resolutions shall remain in full force and effect until expressly revoked in writing served upon The First National Bank of Chicago directed to the attention of the Discount and Collateral Department.

IN WITNESS WHEREOF I have hereunto set my hand the seal of this corporation this

Secretary

CORPORATE SEAL

Figure 103 Resolution for Additional Pledgor to Eliminate Having Executives Sign All Invoices by Hand

C E R T I F I C A T E

The undersigned, , hereby certifies that he is the Secretary of , a corporation, and the keeper of its corporate records and the corporate seal. The undersigned further certifies that the following is a true and correct copy of a resolution which was duly adopted at a duly called meeting of the Board of Directors of said held on ______________________, 19__, a quorum then being present, and that said resolution is set forth in the minutes of said meeting, and that said resolution has not been rescinded or modified:

> RESOLVED, that be, and he hereby is, authorized to pledge or hypothecate as security to The First National Bank of Chicago any accounts receivable of this , and to execute and deliver any and all indorsements or instruments of assignment or transfer which may be necessary or proper to transfer effectively to the said bank the property so hypothecated for delivery.

IN WITNESS WHEREOF the undersigned has hereunto subscribed his name and affixed the seal of said this______________day of______________, 19__.

____
Secretary of

(Corporate Seal)

Figure 104 Form of Waiver Required When Purchase Orders Restrict Assignment

_______________ 19__

____

____

____

Gentlemen

In connection with the financing of our operations we may wish to assign to The First National Bank of Chicago moneys due and to become due under purchase orders received from you We notice that your purchase orders restrict assignment

We presently intend that assignments be made on a non notification basis" and accordingly payments will clear through us unless and until you are notified to the contrary

We wish your written consent to these assignments If agreeable to you, will you kindly execute the form as set forth on the enclosed carbon copy and return it to us for our records

It is understood your consent relates only to the moneys due and to become due and does not include assignment of the performance of the work

Yours very truly

The undersigned hereby consents to the assignment to The First National Bank of Chicago of moneys due and to become due from it to (Insert name of your company)

____

By_______________

Its_______________

Figure 105 A Loan Agreement Used in Loaning against the Assignment of Accounts Receivable

A LOAN AGREEMENT USED IN LOANING AGAINST THE ASSIGNMENT OF ACCOUNTS RECEIVABLE

....
...., 19..

Reliable National Bank
Minneapolis, Minnesota

....
....
....

....
....
....

....
....
....

SECURED BANK CREDIT AGREEMENT

Gentlemen:

The undersigned, ..., a .... corporation (herein sometimes called the "Company") hereby applies to you (herein sometimes called the "Banks") for lines of secured credit to be available from the date hereof until ...., not exceeding the aggregate principal amount of .... Dollars ($.............) at any time outstanding. Such credit lines shall consist of lines of secured credit from each Bank not exceeding the respective principal amounts set forth in the appropriate column opposite its name in the table in Paragraph 1 hereof. Such Bank credit may be used by the Company in whole or in part, for the purposes hereinafter set forth, from time to time, repaid and used again in the discretion of the Company, and shall be available to the Company upon the following terms and conditions in this Agreement (herein sometimes called the "Agreement") set forth:

1. Each Bank, by its acceptance hereof below, agrees to grant secured credit to the Company at any time, and from time to time, from the date hereof until ...., 19.. by making loans to the Company within the limitations, conditions and terms herein set forth. The amount of the commitment of each Bank to make loans until the above mentioned date and the percentage

of the commitment of each Bank to the total commitments are set forth in the following table

Name of Bank	Percentage of Commitment to Total Commitments	Commitments for Loans
Reliable National Bank of Minneapolis	%	$
	%	
	%	
	%	
Total	100%	$

(A) Loans in the amount of $, or some multiple thereof, will be severally made by the Banks to the Company upon closing dates, which may be any business day other than a Saturday, not later than , , to be fixed by the Company by three (3) days' notice in writing to the Banks and Reliable Nat l Bank of Minneapolis as Trustee under this Bank Credit Agreement (hereinafter sometimes called the 'Trustee") against delivery to the Trustee of a promissory note (herein sometimes called the "Notes'), payable to the order of each Bank in substantially the form of Exhibit "A", accompanied by a certificate of the Company signed by its President, a Vice President or its Treasurer in substantially the form of Exhibit "B' Each such Note shall mature but not later than , shall be dated as of the pertinent closing date and shall be in principal amount which is the same proportion of the total loans being made on such closing date as the particular Bank s commitment for loans bears to the total commitments of the Banks All such Notes shall bear interest prior to maturity at a rate of per cent (%) per annum

(B) As compensation for the commitments of the Banks hereunder, the Company agrees to pay the Trustee for the account of each Bank a commitment commission as set forth in the following table on the unused portion of such Bank's commitment from the date hereof until , or earlier termination, such amount to be payable quarterly, commencing

During the Years Set Forth Below	Commitment Commission

By thirty (30) days notice in writing to the Trustee and each of the Banks, the Company may terminate or reduce the commitments in units of $, such reduction to be applicable proportionately to the commitment of each of the Banks and in such event the commitment commission shall, after the effective date of the reduction, be computed upon the commitments as so reduced In case such termination or reduction is made possible by other debt or equity

to the Trustee for the account of each Bank a termination fee of one-fourth of one per cent (¼ of 1%) flat of the amount of its commitment being terminated or reduced.

(C) The Company may prepay any of the Notes from time to time outstanding by five (5) days notice in writing, by paying the principal amount of such prepayment, in the amount of $....... or some multiple thereof, together with interest thereon to the date thereof, but without premium unless the funds for such prepayment are derived directly or indirectly, subject to the provisions of Paragraph 8(f), from other debt or equity financing. In such event, a premium of one-fourth per cent (¼%) flat of the amount of such prepayment shall be paid. All prepayments shall be made proportionately upon the Notes held by the several Banks, having the earliest maturities.

(D) All Notes to be authenticated by the Trustee, shall be executed by the President or a Vice President of the Company and attested by the Treasurer or an Assistant Treasurer of the Company.

(E) Not later than 10:00 A.M., Minneapolis time, on the date specified in each notice for a closing date hereunder, each Bank shall make available to the Trustee at its office, ... Street, Minneapolis 40, Minnesota, in Minneapolis Federal Reserve Bank funds, the amount to be loaned by such Bank. The Trustee shall credit the amount so received from each Bank to the general deposit account of the Company with Reliable National Bank of Minneapolis, against delivery to the Trustee for the account of such Bank of an appropriate note of the Company in the principal amount so loaned by it, accompanied by a certificate in the form prescribed in Paragraph 1(A) above. The note and certificate so delivered to the Trustee for the account of any Bank shall be forwarded by the Trustee to such Bank or upon its order.

(F) Failure of any Bank to extend credit hereunder shall not excuse any other Bank from so doing.

2. The Company represents and warrants that:

(i) It has furnished to each Bank a true and correct copy of (a) its balance sheet as at ...., together with related profit and loss and surplus statements for the twelve months ending that date accompanied by the certificate of independent certified public accountants with reference thereto, and (b) similar unaudited balance sheet as at .... and related similar statements for the .... (....) month period ending that date. Said balance sheets and statements fairly reflect the financial condition of the Company as at said respective dates (including without limiting the generality of the foregoing, all liabilities and adequate provision for contingent liabilities of any type) and the results of operations during the periods indicated. No material adverse change has occurred in the financial condition of the Company as reflected by said balance sheets and statements, since the dates thereof.

(ii) It is a duly organized and existing .... corporation and is duly authorized to make and perform this Agreement and is duly authorized to execute and deliver the Notes.

(iii) The execution of this Agreement does not, and the execution and

delivery of the Notes, and the performance by the Company of its obligations under this Agreement and the Notes, will not violate any provision of law or of the Articles of Incorporation or By Laws of the Company, or any agreement, indenture note or other instrument which is binding upon the Company

(iv) The Company has no subsidiaries and no investment, directly or indirectly in any corporation or entity other than

(v) The Company has no debt of any type for borrowed money and there is no lien upon its property except liens for real estate taxes not yet due.

(vi) The Company is not a party to any material litigation or administrative proceeding nor to the knowledge of the Company in any material litigation or administrative proceeding threatened against it, except

(vii) The Company has outstanding no guaranties, except guaranties of products made in the normal course of business

(viii) The Company is not subject to renegotiation of any war contracts.

(ix) The federal income and excess profits tax returns of the Company have been audited through all fiscal years ending , and no claims are being asserted with respect to any such taxes for any years, except

(x) All representations and warranties contained in this Agreement or in any assignments or other instruments executed pursuant hereto shall survive the execution hereof the making repayment, and successive remaking and repayment of the loans contemplated hereby

3 The Company agrees that all loans to be made hereunder shall be secured by the pledge with the Trustee of "qualified" accounts, as herein defined, satisfactory to the Trustee having a loan value for the purpose of this Agreement of per cent (%) of the unpaid face amount thereof Such pledge shall be made by the execution and delivery to the Trustee of assignments in substantially the form of Exhibit C annexed hereto

"Qualified" accounts receivable (herein sometimes called "Receivable") shall be such accounts receivable (other than accounts which by their terms are unassignable by the Company and accounts owing by employees, federal, state or local government agencies),

(i) which arise out of the business of the Company within the forty-eight states of the United States, with residents thereof, and

(ii) which have a due date of not more than days from the date thereof, which are not more than days past due and are not represented by a negotiable instrument or other writing the surrender of which is required by the obligor s contract with the Company for the enforcement thereof, and

(iii) the goods giving rise to which such account has been shipped to the obligor, and

(iv) the agreement of the obligor to pay which such account is evidenced by an order in writing signed by such obligor, which order is in the possession of the Company or the Agent as herein provided, and

(v) in respect of which there is no pending claim for any credits, allowance or adjustment to obligors on account of returned or inferior or damaged goods, or for any other reason, and

(vi) such account is numbered by the Company and such account number is so indexed that such account, the name of the obligor, address, goods purchased, price, terms and balance owing are all readily ascertainable by reference to such account number, and

(vii) which is subject to no other assignment, and in respect of which there are no defenses, set-offs or counterclaims against payment thereof, and

(viii) which together with all other accounts receivable of the obligor presently assigned to the Trustee represent the total indebtedness of the obligor to the Company for goods sold and unpaid for.

(IF 2nd PARAGRAPH OF 6 IS APPLICABLE, viii ABOVE IS TO BE DELETED)

Anything in this Agreement contained to the contrary notwithstanding, no account receivable owing by a corporation, partnership, entity or any other person domiciled or having a principal place of business in California, Idaho, Michigan, Missouri, North Carolina, Ohio, Texas or Utah shall have any loan value hereunder unless and until there has been furnished to the Trustee evidence satisfactory to it that appropriate notices or certificates have been filed in the appropriate place in pursuance of the statute of such state or states to entitle the assignment of such accounts receivable to the Trustee to a first and prior lien position. Such evidence shall in each instance be accompanied by an appropriate opinion of Company counsel setting forth the pertinent statutory provisions and the manner of compliance therewith. At intervals not longer than three months the Company shall file with the Trustee a certificate stating whether any other state or states have adopted so-called recording or notification statutes pertaining to the assignment of accounts receivable, and in case any additional state or states shall have adopted such statutes, accounts receivable owing by a corporation, partnership, entity or any other person domiciled or having a principal place of business in such state or states shall have no loan value hereunder unless and until there has been furnished to the Trustee evidence satisfactory to it that appropriate notices or certificates have been filed in the appropriate place in pursuance of the statute of such state or states to entitle the assignment of such accounts receivable to the Trustee to a first and prior lien position. Such evidence shall in each instance be accompanied by an appropriate opinion of Company counsel setting forth the pertinent statutory provisions and the manner of compliance therewith.

"Loan value", for all purposes of this agreement, shall mean the value of accounts receivable calculated and determined in accordance with the provisions of this paragraph 3 hereof.

4. The Company covenants and agrees that

(a) It will at all times keep and maintain on deposit with the Trustee, as security for the outstanding Notes at any time issued hereunder, collateral

security of the classifications set forth in Paragraph 3 hereof, having an aggregate loan value at least equal to the aggregate principal amount of all of the Company's Notes from time to time issued and outstanding hereunder; and

(b) If for any reason at any time the aggregate loan value of the collateral security then on deposit with the Trustee shall be less than the principal amount of the Notes of the Company then outstanding hereunder, the Company will forthwith pay the amount of such deficiency or deposit with the Trustee, to be held as part of the collateral hereunder, additional property of the classifications set forth in Paragraph 3 hereof to an aggregate amount sufficient at such loan values to make up any such deficiency

5 The Trustee may rely upon all schedules, whether attached to assignments or otherwise received, as correct and accurate and shall be protected in any action taken in reliance thereon. The Trustee may, however, (but shall not be obligated to) make an independent investigation as to the truth or accuracy of any such statement contained in any such schedule and if such schedules appear to be untrue or inaccurate, may, in its discretion, take or refuse to take any action predicated thereon.

The Company agrees that it will at any time upon request of the Trustee, execute and deliver to the Trustee such other and further instruments, assignments or transfers of the property at any time held by the Trustee hereunder as the Trustee may in its sole discretion deem necessary and advisable in order to effect the assignment and transfer of such property and to subject the same to the terms and provisions of this Agreement.

The Company agrees simultaneously with each assignment to stamp all of its ledger sheets or other records pertaining to accounts so assigned with the following legend "This account assigned to The Reliable National Bank of Minneapolis, Trustee."

For the convenience of the Company and to facilitate the deposit and withdrawal of Receivables pursuant to the terms hereof the Trustee may, from time to time, designate, appoint and remove as its agent a national bank, state bank or trust company doing business in

The Trustee may delegate to any such agent such of its rights, powers and privileges hereunder as it, in its sole discretion, may deem necessary, desirable or proper Such agent shall enjoy all of the immunities herein given or granted to the Trustee under this Agreement in dealing with Receivables at any time deposited with such agent or otherwise.

6 The Company hereby agrees to use its best efforts to collect the amount due on Receivables at any time held by the Trustee hereunder, and the Company agrees that it will forthwith upon receipt transmit and deliver to the Trustee any and all checks, drafts, cash or other remittances which may be received by the Company at any time or times either in payment or on account of all or any of the Receivables at any time held by the Trustee hereunder and that the Company will endorse all such checks, drafts and other remittances in such manner that the same may be collected by the Trustee, and the Com-

pany further agrees that it will not commingle any such checks, drafts cash or other remittances which may be so received by it with any of the Company's funds or property, but will hold same separate and apart from the Company's own funds and upon an express trust for the Trustee until delivery thereof is made to the Trustee.

If a debtor or an obligor whose obligation is a part of the property at any time assigned or transferred to the Trustee hereunder shall also be indebted to the Company on any other obligation or obligations, any general payment made by said debtor or obligor not specifically directed by said debtor or obligor to be applied on any particular indebtedness shall, as between the Company and the Trustee, be conclusively deemed to apply first on the Receivables held by the Trustee hereunder and should any remittance include a payment to the Company of an obligation not comprising part of such property, same shall be forthwith transmitted and delivered by the Company to the Trustee in like manner as set forth in the sub-paragraph next preceding, who shall duly transmit to the Company its check payable to the order of the Company for the amount of the proceeds of such remittance to which the Company is entitled.

(IF 3 (viii) IS APPLICABLE, THE ABOVE PARAGRAPH IS TO BE DELETED)

The Company agrees that if any debtor, owing any account receivable at any time assigned to the Trustee hereunder, refuses to retain or shall return any of the merchandise from the sale of which the account arose, the Company will immediately notify the Trustee thereof, explaining why such merchandise was returned, and the Company hereby sells, assigns, transfers, sets over and pledges to the Trustee, all merchandise which may be so returned. All such returned merchandise shall be set apart from the Company's own merchandise and be plainly labeled as having been pledged to the Trustee, and the Trustee is hereby given a lien upon and the right to sell such returned merchandise at public or private sale without advertisement and to become the purchaser thereof at any public sale thereof. The Company does further agree that within ten days after notice to the Company of the refusal of any such debtor to accept or retain any such merchandise, it will assign, transfer and pledge to the Trustee other property of the classifications set forth in Paragraph 3 hereof; acceptable to the Trustee, in lieu thereof, having a loan value equal at least to the loan value of the amount which arose from the sale of the merchandise so returned, whereupon the lien of the Trustee upon said merchandise and all of the Trustee's rights in respect thereof shall cease.

7. So long as none of the events of default specified in Paragraph 13 hereof, nor any event which with the passage of time or service of notice or both would constitute a default thereunder, shall have happened or occurred, such withdrawal of collateral security hereunder by the Company being of itself a representation of the Company that the same has not happened or occurred, and subject to the requirements of Paragraph 4 hereof,

(a) the Trustee shall permit the Company from time to time to withdraw any property at any time held by it as security hereunder, including the cash

proceeds thereof, upon the simultaneous substitution of other property of the classifications described in Paragraph 3 hereof, having a loan value at least equal to the loan value of the property so withdrawn

(b) whenever, from time to time, the aggregate loan value of the property on deposit with the Trustee hereunder shall exceed one hundred per cent of the aggregate principal amount of all of the Company's Notes then outstanding under this Agreement, the Company shall be permitted to withdraw, in the amount of $ or some multiple thereof, property, or the cash proceeds thereof, having a loan value equal to such excess

The Trustee shall at least twice a month, so long as none of the events specified in Paragraph 13 of this agreement, shall happen or occur, apply all payments made to it under Paragraph 6 of this agreement, together with all other appropriate payments, collections or realizations, received by it and not withdrawn, to the pro rata payment of the principal of the outstanding Notes

In handling matters under this paragraph the Trustee in its discretion and without liability may treat as cash uncollected cash items, such as checks

8 The Company covenants and agrees that

(a) If any account receivable appears, in the sole judgment of the Trustee, to be uncollectible, or same remains unpaid for more than thirty days after its actual due date as certified to the Trustee by the Company, even though such due date be subsequent to the due date indicated by the invoice representing such account, substitution of other property of the classification set forth in Paragraph 3, will promptly be made by the Company, which shall have a loan value at least equal to the original loan value of the accounts receivable which shall have so appeared to be uncollectible or which shall not have been paid

(b) The Company will procure and at all times maintain in full force and effect insurance containing mortgage clauses payable to the Trustee where appropriate in good and responsible companies covering to their full insurable value, all property to the extent that such property is usually insured by other companies in a similar business In addition, the Company will maintain such other insurance as may from time to time be reasonably requested by any Bank and will also furnish the Trustee and the Banks from time to time with full information as to the amount, name of company, policy number and character of all insurance carried

(c) The Company will furnish to the Trustee and each of the Banks, (i) on or before the last day of each month, a balance sheet and operating statement of the Company for the preceding month, provided, however, that the balance sheet and operating statement for the last month of each fiscal year and the first two months of the new fiscal year may be tentative, pending adjustments to be shown by the annual audits of the books, records and accounts of the Company prepared by independent auditors, and (ii) within 90 days after the close of each fiscal year, a complete audit report prepared by Certified Public Accountants acceptable to the Banks, including a balance

sheet, profit and loss statement and surplus reconciliation and (iii) within fifteen (15) days after the close of each month a schedule showing the loan value of each item of collateral held by the Trustee hereunder as of the close of such month together with all borrowings and collections upon such Receivables, in substantially the form of Exhibit D.

(d) The Company will maintain current assets equal to or in excess of .... *more than current liabilities.*
The Company's current assets and current liabilities for all purposes of this agreement shall mean, respectively, the total of such assets located in the United States and the total of such liabilities (including all Notes and all accruals, and particularly, without limiting the generality of the foregoing, tax accruals and the amount of any tax assessed regardless of the contest thereof) determined in accordance with accepted principles of accounting.

(e) The Company except with the consent of the Banks shall not create, incur, or suffer to exist any indebtedness for borrowed money except under this Agreement and within the limits permitted by subparagraph (f) above.

(f) The Company will not create or incur or suffer to exist any pledge, mortgage, assignment or other encumbrance of or upon any of its assets or property now or hereafter owned or of or upon the income or profits thereof, nor make any transfer or assignment of receivables with or without recourse; provided, however, that (i) with the consent in writing of the Banks at such times as the credit provided by this Agreement is being fully utilized, the Company may pledge Receivables as security for current borrowings made in the normal course of business on a collateral ratio not greater than that established by the loan values prescribed by Paragraph 3, so long as the Company first offers to make such current borrowings from the Banks and (ii) irrespective of the limitation in this subdivision (f) or elsewhere in this Agreement contained, the Company may at any time, subject to the provisions of Paragraph 1(C), prepay all of the Notes then outstanding and secured hereby, and for that purpose, should the Company so elect, may arrange such financing or refinancing as may seem to be necessary or desirable. Upon such prepayment all property of every kind and nature then held by the Trustee to secure said Notes shall, after the payment of the advances of the Trustee, costs and charges, be unconditionally released by the Trustee to the Company, and the provisions hereof shall in all respects cease to be effective.

(g) The Company will not pay any dividends upon the Company's capital stock of any class (except dividends payable in its own common stock) nor purchase, redeem or otherwise acquire or retire any of its capital stock of any class except...
....

(h) The Company will maintain its corporate existence and will so comply with all the laws of the state in which it is organized and in the various states in which it does business, and will so observe, keep and perform all rules, regulations, laws, ordinances and statutes, both state and federal, or of

any subdivision thereof that it will not suffer the loss of any basic license or permit necessary in the operation, maintenance and performance of its corpo rate affairs In the event of such loss of any basic license or permit, the same shall not be deemed to be an event of default hereunder except upon un animous action of the Banks declaring the same to be a default

(i) The Company will promptly pay and discharge all taxes, assessments and governmental charges heretofore and hereafter imposed, assessed or levied against it or against its assets, as well as all claims for labor, materials or supplies which, if unpaid, might by law become a lien or charge upon any property of the Company, except that nothing herein contained shall prevent the Company either before or after or with or without payment from law fully contesting, in good faith, by appropriate proceedings anv such tax, assessment, governmental charge or such claims that may be imposed, assessed, threatened or levied against it or from adjusting or compromising the same and the manner of the payment thereof

(j) The Company has legal title and is lawfully possessed of all property at any time assigned, transferred and deposited to and with the Trustee hereunder, that it has good right and lawful authority to sell, assign, use, transfer, pledge and negotiate the same, and that the same will be true of all property hereafter assigned, transferred and deposited, and that it will warrant and defend the same to the Trustee for the benefit of the Banks against the claim and demand of any person whomsoever

(k) The Company will not become a guarantor of any obligations of or an endorser or otherwise liable upon any notes or obligations of any person or corporation except in connection with depositing checks and negotiable instruments in the normal course of its business, and except for guaranties made by the Company of its products in the normal course of its business

(l) The Company will not make or permit to exist any loans or advances to or any investments in any other person or corporation except that the Company may (a) purchase United States Government Bonds and obliga tions, and (b) make and permit to continue to exist loans or advances to or investments in other persons or corporations, so long as the aggregate amount of such loans, advances and investments at any one time outstanding

(m) The Company will not create or participate in the creation of any corporation or other entity and will carry on and conduct its business in substantially the same manner and in substantially the same fields as such business is now and has heretofore been carried on

(n) The Company will not merge or consolidate with, or into, any other entity, or lease or sell all, or substantially all, of its property, assets and busi ness to any other entity or dispose of or sell any substantial portion of its assets or property except in the ordinary course of business

9 The Trustee may at any time (but shall be under no obligation to) give notice to any debtor of the assignment to it of any Receivables and the Com

pany will immediately at any time upon the request of the Trustee, notify in writing all obligors and debtors under Receivables assigned or transferred to the Trustee under the terms of this Agreement of the fact of such assignment and direct all such obligors and debtors to make payment of their obligations and indebtedness directly to the Trustee.

10. The Trustee and the Banks, or any of them, may from time to time appoint one or more representatives to examine the books, accounts, and records of the Company, and the Company agrees that the said books shall at all reasonable times be free of access to and open for inspection and copying by the Trustee and the Banks and their representatives.

11. The Company agrees to pay and satisfy all reasonable fees, expenses and advances of the Trustee and its agents, employees and attorneys and counsel incurred in and about the conduct of the affairs of the trust created by this agreement, and the Trustee is hereby given a first and prior lien on all property at any time held by it hereunder, as security for the payment of all such fees, expenses and advances.

12. If the Company becomes insolvent, however evidenced, or any default occurs or any attachment of any balance of the Company is contemplated or any other event occurs conferring upon any Bank the right to make any offset of indebtedness, any indebtedness from the Banks to the Company may be offset and applied toward the payment of the Note or Notes held by such Bank, whether or not such Note or Notes, or any part thereof, shall then be due. In case at any time any Bank, whether by set-off or otherwise, has payment made to it upon its Note or Notes in a greater proportion than payments made on the Note or Notes held by the other Banks, such Bank so receiving such greater proportionate payment agrees to purchase a portion of the Note or Notes held by the other Banks so that after such purchase each Bank will hold an unpaid balance of a Note or Notes bearing the same proportion to the total principal amount of Notes at such time outstanding as existed in the original loans made by the Banks. In case any such payment is disturbed by legal process, or otherwise, appropriate further adjustments shall be made.

13. In the event that any one or more of the following events (herein and in the Certificate, Exhibit "B," called "default" or an "event of default") shall happen or occur, that is to say, if

(a) The Company shall fail punctually to pay when due interest or principal on any of the Notes issued, outstanding and secured by this Agreement; or

(b) The Company shall fail to keep, observe or perform any other covenant, condition, term or provision of this Agreement required to be kept, observed or performed by it, and the Company shall not remedy such default within fifteen (15) days after written notice thereof to the Company by the Trustee; or

(c) Any representation or warranty of the Company to any Bank under this Agreement or any certificate, accounts or other information furnished in connection with this Agreement shall be materially false; or

(d) Proceedings in bankruptcy or for reorganization of the Company or for readjustment of any of its debts under the Bankruptcy Act as amended, or any part thereof or under any other act or law, whether state or federal, for the relief of debtors now or hereafter existing, shall be filed by the Company, or

(e) Proceedings in bankruptcy or for reorganization of the Company or for readjustment of any of its debts under the Bankruptcy Act as amended, or any part thereof, or under any other act or law, whether state or federal for the relief of debtors now or hereafter existing, shall be filed against the Company and be approved as properly filed or remain undismissed for thirty (30) days, or

(f) A receiver is appointed for the Company or for all or substantially all of the assets of the Company and said receiver be not duly discharged within fifteen (15) days from his appointment, or

(g) An assignment is made by the Company for the benefit of creditors, or

(h) A final judgment in excess of ______ is entered against the Company which remains unsatisfied for more than thirty (30) days, unless said judgment has been duly bonded or stayed pending an appeal,

then and upon the happening of any one of such events all of the Notes of the Company issued under the terms of this Agreement shall become immediately due and payable, without demand or notice of any kind, and the Banks and each of them shall thereupon be free forthwith to enforce payment of the said Notes of the Company Upon the happening of any default, or any event which with the passage of time or service of notice or both would constitute such default, the rights of the Company to borrow additional money or to make any withdrawals or substitutions of any property held by the Trustee hereunder shall forthwith terminate

14 The Trustee, upon the happening of any default may thereupon and upon the written request of a majority in number and amount of the Banks shall, exercise all or any of the following powers for the protection and enforcement of the interests and rights of the Trustee and of the Banks, namely

(a) The Trustee, in such manner as in its discretion it shall deem best, may collect all sums due or to become due for principal or interest upon the property then held hereunder, and may institute and maintain any suits or proceedings against the makers, obligors endorsers, or guarantors of any of said property or others, and may enforce any security therefor and may take any other steps it may deem advisable to obtain payment of or realization upon any of said property

(b) The Trustee, personally or by any agent or attorney selected by it, may sell all or any part of the property then held by the Trustee hereunder and all right, title, interest, claim and demand therein and the right of redemption thereof, at public or private sale or sales, in the City of Minneapolis, Minnesota, or at such other place or places and at such time or times and

upon such terms as the Trustee may fix, upon 5 days' notice to the participating banks and the Company but without any advertisement thereof.

The Trustee may adjourn from time to time any sale hereunder by announcement made at the time and place appointed for such sale or at the time and place appointed for an adjourned sale or sales, and without further notice it may make such sale at the time and place to which the same shall be so adjourned.

Upon the completion of any sale or sales under this Agreement, the Trustee shall assign, transfer and deliver to the accepted purchaser or purchasers such of the property as shall have been sold to said purchaser or purchasers and such assignment, transfer and delivery shall be conclusive evidence of the validity of the transfer thereby effected.

The Trustee and its successors hereby are appointed the true and lawful attorney or attorneys irrevocable of the Company in its name and stead to make any necessary assignments and transfers of the property thus sold, and for that purpose it and they may execute all necessary instruments of assignment and transfer and may substitute one or more persons with like power, the Company hereby ratifying and confirming all that its said attorney or attorneys or such substitute or substitutes shall lawfully do by virtue hereof.

The receipt of the Trustee for the purchase money shall be a sufficient discharge therefor to any purchaser of the property, or any part thereof, sold as aforesaid and no such purchaser or his representative, grantees or assigns, after paying such purchase money and receiving such receipt, shall be bound to see to the application of such purchase money upon or for any trust or purpose of this agreement or shall in any manner whatsoever be answerable for any loss, misapplication or nonapplication of any such purchase money or shall be bound to inquire as to the authorization, necessity, expediency or regularity of any such sale or sales.

Upon any sale of all or any part of the property by the Trustee, the Trustee or any of the Banks or any group of them or any other persons or persons may bid for and purchase the property offered for sale, or any part thereof, without accountability in respect thereof except for payment of the purchase price; and in any settlement or payment of the purchase price of the property purchased, shall be entitled to use and apply any Notes issued under this Agreement by presenting such Notes in order that there may be credited thereon the sums applicable to the payment thereof out of the net proceeds of such sale after making the deductions allowable hereunder for the costs and expenses of the sale or otherwise, and thereupon such purchaser shall be credited on account of such purchase price payable by him with the sums so applicable to payment of or be credited on the Notes so presented.

All remedies granted to the Trustee and to the Banks are hereby declared to be cumulative and no right or remedy shall be exhausted by any one exercise thereof.

15. The net proceeds and avails of sales of any property and the net proceeds of all collections of or realizations on any property, together with any

sums which may then be held by the Trustee under any provision of this Agreement, together with all other moneys which may come into the possession of the Trustee as realization upon any property held by it hereunder, shall be applied from time to time as follows

First To the payment of the costs and expenses of collection and of any such sale, including a reasonable compensation to the Trustee, its agents, attorney and counsel, and of all other reasonable expenses, liability and advances made or incurred by the Trustee

Second To the payment of the whole amount of the principal and interest then owing or unpaid on all the Notes then outstanding hereunder, together with interest at the rate of five per cent (5%) per annum upon past due installments of principal and interest In case such proceeds shall be insufficient to pay in full the whole amount of the principal and interest then owing or unpaid, together with interest on overdue installments as aforesaid, the proceeds shall be applied first to the payment of unpaid principal and second to the payment of interest, ratably without preference or priority of any one Note over any other Note

Third After payment in full of all such sums, the payment of the surplus, if any, to the Company, its successors or assigns, or whomsoever shall then be lawfully entitled to receive the same

16 The Trustee shall not be liable or responsible for the value or validity of any Receivables or assignments or transfers thereof, security therefor, or for the validity, collection or enforcement of any of the Notes, or for the value, enforceability or validity or other effect of the assignment or pledge of any Receivables, nor shall the Trustee be under any obligation or liability for the use by the Company of the proceeds of any of the loans which may be made to the Company hereunder, or for the application thereof, or for the application of any moneys credited to the account of or paid to the Company upon its order The Trustee shall not be obliged to see to the existence or maintenance of any insurance The Trustee may act upon or in accordance with any order, letter, assignment, certificate, instrument, receivable, note, release, statement, report, document or other paper believed by it to be genuine and to have been signed, endorsed or presented by the Company, and the Trustee is expressly relieved from any liability or responsibility therefor to the Company, to any of the Banks or to any other person The Trustee shall not be liable to account for property, collections or realizations on property at any time assigned or transferred to it hereunder until such amounts are actually received and collected by it The Trustee shall not be answerable for any default, neglect, error or misconduct of any agent appointed by it in pursuance hereof if such agent shall have been selected with reasonable care The Trustee shall not be required to take notice of the occurrence of any default hereunder, or to take any action in respect of any default, and may for all purposes conclusively assume that there has been no default hereunder unless and until notified in writing thereof and requested to take action in respect thereto by a majority in number

and amount of the Banks, and unless tendered indemnity satisfactory to the Trustee against all reasonable expenses or liability in connection therewith, or arising therefrom. Finally and generally, the Trustee and its officers, directors and agents shall not be liable to the Company or to the Banks, for the exercise of its discretion hereunder, or for any mistake of judgment, or for any action taken, or for any omission with respect to any action or thing arising hereunder, except for its own want of good faith.

17. Any delay or omission of the Trustee or the Banks to exercise any rights or powers arising from any default, shall not impair any such rights, or powers nor shall the same be considered to be a waiver thereof or any acquiescence therein, nor shall the action of the Trustee or the Banks in the event of any default affect or impair the right of the Trustee or the Banks in respect of any subsequent default or impair any rights or powers resulting therefrom.

18. The obligations of the respective Banks under this agreement are several and not joint, and neither is nor shall be construed to be a partner or agent of the other. Each Bank represents and warrants that it is acting for its own account to employ a portion of its available loanable funds, and that it is not acquiring the Notes deliverable to it hereunder with a view to their sale or distribution, and that no public offering shall be made of the whole or any part thereof.

19. The Trustee may resign at any time, and upon such resignation a successor Trustee shall be named by a majority in participating amount of the Banks. The said successor Trustee shall be a national or state bank or trust company in good standing and having a capital and surplus amounting to at least $1,000,000.00. Any successor trustee appointed hereunder shall execute, acknowledge and deliver to the Company an instrument accepting such appointment herein, and thereupon such successor trustee shall become vested with all the estates, properties, interests, rights, powers and trusts, and, as well, with all the functions of its predecessor hereunder with like effect as if originally named as Trustee herein, without any further act, deed, transfer or conveyance. Any company into which the Trustee may be merged or with which it may be consolidated, or any company resulting from any merger or consolidation to which the Trustee shall be a party shall be the successor to the Trustee herein without the execution or filing of any instrument or document or other further act on the part of the parties hereto, anything herein contained to the contrary notwithstanding.

20. The Company may fix dates for closings hereunder (in this Agreement sometimes called "closing dates") on business days on or prior to the time specified in Paragraph 1. The Banks shall not be required to make loans contemplated by this Agreement unless closing dates are so fixed to occur on or before such date, nor unless prior to or concurrently with the making of loans the Company shall have fulfilled the following conditions:

(A) On or before the first closing date the Company shall have furnished to the Trustee for each Bank:

(a) Copies certified by the Secretary or Assistant Secretary of the Company, of the Company's Articles of Incorporation as amended, By Laws, Board of Directors Resolutions (and resolutions of other bodies, if any are deemed necessary by counsel for the Banks) authorizing the execution of the Notes and this Agreement, and

(b) A written opinion of the Company's counsel addressed to the Banks stating that the Company is validly organized and existing and is authorized to do business in the localities in which it conducts its business, that this Agreement has been validly executed by the Company and the agreements herein contained are binding upon it, that the Notes to be issued hereunder will upon execution and delivery be valid obligations of the Company in accordance with their terms, that neither the agreements on the part of the Company herein contained, nor the issuance by the Company of Notes here under nor performance by the Company of any of its obligations hereunder or under the Notes, do or will violate any provision of law, the Articles of Incorporation of the Company as amended or its By Laws or any agreement, indenture, note, or other instrument which is binding upon the Company, that the pledge of Receivables contemplated by this Agreement will create a good and valid first lien thereon as security for the Notes, that no action or non-action by any governmental bureau, agency or commission is requisite to the validity or enforceability of the Notes or this Agreement or, to the extent that the same may be necessary, it has been properly procured.

(c) A true and correct certificate in the form of Exhibit "B" attached hereto

(B) On each subsequent closing date the Company shall furnish to the Trustee for each Bank a true and correct certificate in the form of Exhibit "B" attached hereto

21 Whenever in this agreement any provision is made for notice or demand to or upon the Company, or if at any time the Trustee or the Banks or any of them shall desire to give notice or make demand to or upon the Company, such notice or demand may be given by registered mail, directed to the Company at   , or at such other place as the Company shall have previously designated in writing, and an affidavit by an officer of the Trustee or by any person in its employ or representing or acting on behalf of the Trustee, as to such mailing shall be sufficient evidence as to the giving of such notice or the making of such demand

22 The Company agrees that if any taxes shall be payable or ruled to be payable, either by any federal or state authority, in respect of this Agreement or any of the Notes or the execution or delivery or issuance of any thereof, by reason of any now existing or hereafter enacted federal or state statutes, it will pay all such taxes so far as it may lawfully do so, including interest, if any, and will indemnify and hold the Trustee and any holder of the Notes harmless and indemnified against any liability or liabilities with respect of or in connection with any such taxes.

23 This agreement shall be binding upon and inure to the benefit of the

parties hereto and the respective successors and assigns of the Banks, and shall not inure to the benefit of any other person, firm or corporation.

24. This agreement is subject to final acceptance in Minnesota and shall be construed in accordance with the laws of Minnesota.

25. This agreement may be executed in any number of counterparts, each of which shall be deemed to be an original.

The acceptance hereof by the Banks and approval by the Trustee shall constitute this instrument an agreement between and among the Banks, the Trustee and the Company.

Yours very truly,

....

By ....
Its President

Attest:

....
Its Secretary

The foregoing instrument is hereby accepted as of the date first above written by the undersigned Banks which agree to furnish the lines of credit and make the loans therein applied for on the terms and conditions therein set forth.

RELIABLE NATIONAL BANK
OF MINNEAPOLIS

By ....
Vice-President

....

By ....
Vice-President

....

By ....
Vice-President

....

By ....
Vice-President

The undersigned agrees to act as Trustee under the foregoing Bank Credit Agreement, subject to the terms and upon the conditions therein set forth.

RELIABLE NATIONAL BANK
OF MINNEAPOLIS

By

Vice President

EXHIBIT "A"

$, 19

FOR VALUE RECEIVED, the undersigned, , a corporation, promises to pay to the order of the principal sum of

DOLLARS ($) payable in lawful money of the United States at the office of Reliable National Bank of Minneapolis as Trustee, , Minneapolis Minnesota, on the of , 19 , together with interest from date hereof until maturity at the rate of per cent (%) per annum, payable monthly on the fifth day of each month and at maturity and with interest after the expressed or any accelerated maturity at the rate of five per cent (5%) per annum

This Note is subject to the provisions of a Secured Bank Credit Agreement under date of , 19 , between and among the Company, Reliable National Bank of Minneapolis, , and , to which Agreement reference is hereby made for a statement of the terms and conditions under which the loans in part evidenced hereby were made, are secured and are to be repaid, and under which this Note may be paid prior to its due date or its due date accelerated This is one of the Notes mentioned in such Agreement.

By

President

The above Note is one of several Notes issued and which may be issued under and secured by the terms and provisions of a certain Secured Bank Credit Agreement dated , 19 , between and among

......................, a .... corporation, certain Banks and Reliable National Bank of Minneapolis as Trustee, and is entitled to the benefits of said Agreement.

Dated:............................

RELIABLE NATIONAL BANK
OF MINNEAPOLIS
As Trustee under the above mentioned
Agreement

By ....
Authorized Officer

EXHIBIT "B"

....
...................., 19..

TO–

Reliable National Bank of Minneapolis,
Trustee under Secured Bank Credit Agreement between and among ....
.... and various Banks
dated ...., .., 19.., and
Each of the Banks parties to such Agreement

Gentlemen:

I, ..., ... of ....
........................, a .... corporation, do hereby certify that as of the date hereof no event of default exists, under the Secured Bank Credit Agreement dated ...., 19.. among and between Reliable National Bank of Minneapolis as Trustee, and other Banks named therein, and that no event which, with the giving of notice or the lapse of time, or both, may become an event of default under said Agreement exists, and that this certificate is made and furnished to induce said Banks to make $.............. of loans pursuant to such Agreement.

I do further certify that no tax lien exists or is asserted against the Company or any of its assets.

I do further certify that the loan value of collateral on deposit with the Trustee under said Agreement as defined therein is $.............. in ac-

cordance with Schedule "A" attached hereto and that the aggregate of Notes outstanding hereunder after the making of loans on this date will not exceed such loan value

I do further certify and warrant that the proceeds of the loans being made to in reliance upon this certificate will be used solely for the purposes of

EXHIBIT C

For Value Received, the undersigned hereby sells, assigns, transfers and sets over unto Reliable National Bank of Minneapolis as Trustee under agreement dated , 19 between , certain banks and the Trustee (hereinafter called the "Trustee"), all the right, title and interest of the undersigned in and to the accounts receivable and sums (specified on the Schedule hereto attached and made a part hereof) due, and to become due, to the undersigned at the times in said Schedule specified, from the persons, firms and corporations whose names are in said Schedule specified together with all security pertaining thereto

Said accounts receivable and sums are evidenced by invoices, copies of which are herewith delivered to said Trustee, and the undersigned expressly warrants that the names and the sums and the due dates thereof are correctly stated in said Schedule and invoices, that all items covered by such invoices have been duly delivered to the purchasers thereof, that said sums are now, or will be, due and payable to the undersigned (had this assignment not been given) when and as specified in said invoices and Schedule, that no other assignments of any of said sums have heretofore or will hereafter be made, and that there are no defenses, set offs or counterclaims against the payment of said sums The undersigned hereby unconditionally guarantees the due and prompt payment to the Trustee of said accounts

The Trustee is hereby expressly authorized and empowered to ask for, demand, collect, institute and maintain suits for, receive, compound, compromise and give acquittances for, any and all sums owing, which are now or may hereafter become due upon said accounts hereinbefore referred to, to enforce the payment thereof either in its own name or in the name of the undersigned, and to endorse the name of the undersigned on checks and other instruments tendered or received in payment of said accounts

The undersigned further hereby agrees that the undersigned will, forthwith upon receipt, transmit and deliver to the Trustee, any and all checks, drafts, cash or other remittances which may be received by the undersigned at any time or times, either in payment or on account of all or any of the accounts

hereinbefore referred to, and that the undersigned will endorse all such checks, drafts and other remittances in such manner that the same may be collected by the Trustee, and the undersigned further agrees that the undersigned will not commingle any of such checks, drafts, cash or other remittances, which may be so received by the undersigned, with any of the undersigned's funds or property but will hold the same separate and apart from the undersigned's own funds and upon express trust for the Trustee until delivery thereof is made to the Trustee.

The undersigned further agrees that, immediately upon the execution hereof, the undersigned will record on all of the undersigned's records and books of account, showing or dealing with said accounts hereby assigned, a notation clearly setting forth that said accounts have been assigned to the Trustee on this date.

The undersigned further agrees that if any debtor owing any account hereby assigned refuses to retain or shall return any of the merchandise from the sale of which the account arose, the undersigned will immediately notify the Trustee hereof, explaining why such merchandise was returned, and the undersigned hereby sells, assigns, transfers, sets over and pledges to the Trustee, all merchandise which may be so returned. All such returned merchandise shall be set apart from the undersigned's own merchandise and be plainly labeled as having been pledged to the Trustee, and the Trustee is hereby given a lien upon and the right to sell such returned merchandise at public or private sale, without advertisement, and to become the purchaser thereof at any public sale thereof. The undersigned does further agree that within ten days after notice to the undersigned of the refusal of any such debtor to accept or retain any such merchandise that it will assign, transfer and pledge to the Trustee other accounts receivable acceptable to the Trustee in lieu thereof having a loan value (determined in accordance with said agreement dated ...., 19..) equal at least to the loan value of the account which arose from the sale of the merchandise so returned whereupon the lien of the Trustee upon said merchandise and all of the Trustee's rights in respect thereof shall cease.

The rights and remedies of the Trustee hereunder are cumulative and are not in lieu of, but are in addition to, any other rights and remedies which the Trustee may have under the provisions of said agreement dated ...., 19...

This assignment shall be binding upon the undersigned and its successors and assigns, and shall inure to the Trustee and its successors and assigns.

IN WITNESS WHEREOF, the undersigned has duly executed this instrument at ...., this ....day of ...., 19...

....

By ....
Authorized Officer or Agent.

SUGGESTED READINGS

"Accounts Receivable Financing" New York Credit Policy Commission, American Bankers Association, 1957

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"Pennsylvania Banks and the Uniform Commercial Code" Pennsylvania Bankers Association, Harrisburg, Pa This was written in laymen's language and would be very helpful to anyone desiring to study the code

PHELPS, CLYDE WILLIAM *Accounts Receivable Financing as a Method of Business Finance* Baltimore Commercial Credit Company, 1957

RAYMOND J SAULNIER and NEIL H JACOBY *Accounts Receivable Financing* New York National Bureau of Economic Research, 1943

SCHOOL OF LAW, Duke University, Durham, North Carolina. 'Secured Commercial Financing," *Law and Contemporary Problems*, Vol XIII, No 4 (Autumn 1945)

SILVERMAN, HERBERT R. "Factoring as a Financing Device," *Harvard Business Review* (September 1949), pp 594–611

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chapter XVII

INSTALMENT CREDIT

Instalment loan and financing transactions are the major components of the broad consumer credit category. At the close of 1939 consumer credit outstanding had reached $7,222,000,000. Of that amount, $4,503,000,000 was instalment credit, and the remainder, charge account credit, service credit, and single payment loans.

By the end of 1960 consumer credit outstandings had grown to $56,-049,000,000 of which $43,281,000,000 was instalment credit.

It was during the intervening twenty-one years that banks made their greatest progress in the field of instalment credit. A number of factors contributed to this progress. Banks became increasingly aware of the social, economic, and political significance of all forms of consumer credit. In addition, they observed the successful operation of many consumer loan and financing agencies over a period of many years. Also, the experience gained by many banks in making loans under the provisions of Title I of the National Housing Act furnished convincing proof to them that instalment credit could be extended to qualified individuals on a safe and profitable basis.

At the close of World War II substantial amounts of loanable funds were available to banks. The demand for these funds was relatively small, and interest rates on loans and investments were abnormally low. Instalment credit became a popular subject of discussion for progressive bankers seeking to serve better their customers and communities and to employ their funds more profitably. The American Bankers Association through its Instalment Credit Commission did much to promote the extension of instalment credit by banks and continues to do so through its conferences, operating manuals, and other educational programs.

Bankers embraced this new field of credit with varying degrees of en-

thusiasm Many employed the most capable men available in the instalment credit field and proceeded to build the business as rapidly as possible Others preferred to utilize bank personnel and proceeded cautiously to learn by experience In a relatively few years, instalment credit had earned a position of prominence in most banks and stood shoulder to shoulder with the other major loan and deposit services of banks In the process, banks have saved the buying and borrowing public many millions of dollars in loan and financing charges by keeping rates to the public relatively low

That banks have become the dominant factor in extending instalment credit to the public is illustrated by the fact that $16,398,000,000 of the $43,281,000,000 of such credit outstanding on December 31, 1960[1] was held by banks Sales finance companies had $11,134,000,000 in instalment credit outstanding on that same date, with the remainder held by retail outlets, consumer finance companies, credit unions, and other financial institutions

TYPES OF INSTALMENT CREDIT

Instalment credit has often been defined as an extension of credit re payable in two or more definitely scheduled instalments Basically there are two types of instalment credit The first and major type is sales financing, which is the purchase of a commodity or service on instalment terms In a sense this could be likened to an enforced savings program For a credit service fee the buyer can obtain the use of the product or service while accumulating the amount of the purchase price Nearly 75 per cent of the instalment credit outstanding is sales financing, or instal ment sale credit.

The remainder is what is generally described as personal loan, or cash, credit. Much of this is traceable to sales financing, since a large portion of personal loan credit is extended for the purpose of assisting borrowers to adjust budgets that may have become unbalanced as the result of imprudent purchasing, changes in income, or other circumstances affecting a person's ability to meet financial obligations However, personal loan credit is extended for other than remedial purposes The budgeting of large cash requirements, such as college fees, medical and dental expenses, business investments, and other items which are more conveniently repaid on instalment terms, is often accomplished through the use of personal loan credit

[1] *Federal Reserve Bulletin* (October 1961), p 1222

BANK POLICIES

The economic life of the majority of American families involves the use of some form of instalment credit. To meet the needs of their customers and to retain their good will, most banks find it desirable and necessary to furnish an instalment credit service. The instalment credit transactions handled by a bank generally outnumber other loan transactions by a wide margin. The scope of this service is a matter that each bank decides for itself. The decision hinges on many factors. Perhaps the most important is the knowledge and ability of the officers and staff to whom the responsibility for the business is assigned. When the staff is skilled and experienced in all phases of direct lending and dealer sales financing, the bank is able to derive the maximum benefit from an instalment credit operation. On the other hand, if the staff lacks experience, the bank will proceed more cautiously until it has determined that the business is being handled safely and profitably.

The character of the competition in the market served influences the policy decisions of the bank. Generally speaking, banks do not attempt to compete on an equal basis with every other bank or loan and finance company in their area. Since banks generally charge lower rates than non-bank competitors, they cannot afford to expose themselves to the same degree of risk. This also applies to dealer sales financing arrangements. As a result, it is not uncommon to find that bank policies are more conservative than those of finance and loan companies.

Restrictions imposed by regulatory agencies or statutes sometimes require a bank to adopt policies that limit their freedom of action in some phase of lending. For example, it is possible that a state may have a law limiting maturities on instalment credit transactions to thirty-six months, but exempting government-insured or guaranteed obligations. This would mean that, to offer five-year terms on a home improvement transaction, the bank must operate under the provisions of Title I of the National Housing Act. Banks often are not permitted to charge the same rates granted to licensed loan and finance companies. Special statutes covering instalment credit transactions have been enacted by many states. Banks are careful to comply with the spirit as well as the letter of all such laws and regulations.

The amount of funds that can be allocated to instalment credit is an important consideration in formulating policies. If funds are limited, it may be necessary to confine operations to direct lending on a highly se-

lective basis. It is rare that a bank discontinues an instalment credit service for lack of available funds, since the public's reaction to such measures would almost certainly have a serious effect on the future of the bank.

Economic conditions in the community served by the bank are weighed along with the other considerations in making policy decisions. The bank in a town that has only one major industry has an unusual business hazard to evaluate. The sale or removal of the industry, its failure, labor difficulties, all could create abnormal collection expenses and losses, since most of the bank's instalment credit would have been extended to employees of that industry.

By carefully evaluating all the factors involved, the bank will develop a policy for each of the following items:

1. Types of credit to be offered.
2. Methods to be used to make the credit available to the public.
3. Credit standards to be established.
4. Operating procedures.
5. Rates to be charged on each type of credit.
6. Maturities for each type of credit.
7. Minimum and maximum loan amounts for each type of credit.

Business Development Methods

Since there are many agencies competing for instalment credit business, any bank desiring to acquire a substantial volume of business must take aggressive steps to build the business.

Direct loan business is most successfully secured through broad and diversified promotional efforts. The media employed include newspapers, radio, television, direct mail, statement enclosures, booklets, lobby displays, car cards, and billboards. Repeat borrowers often account for a large portion of direct loan volume, but it is necessary to cultivate new customers on a sustained basis to maintain adequate volume. Borrowers using direct loan services usually become loyal customers as long as they are fairly treated, and such relationships often bring other benefits to the bank.

While advertising and other promotional efforts create customer acceptance of a bank's service, dealer business must generally be acquired through solicitation by an officer or a member of the instalment credit staff to be successful, the bank's representative must be able to convince the dealer that its plan offers him advantages to be found in no other

plan. The advantages involve the extent of liability the dealer is required to assume, the amount of reserves or commissions to be paid, the speed of the credit service, the liberality of the bank's credit standards, its collection policies, rates, and the interest shown by the representative and the bank staff in making the bank's credit service an important sales tool for the dealer.

Personnel

Instalment credit is a retail business and as such requires a staff of sales-minded officers and employees. The extension of instalment credit to individuals and families has long ceased to be a form of credit for a selected few. Hence, as in the sale of merchandise, the consummation of profitable transactions requires alert, tactful, courteous, and friendly personnel competent to deal with large numbers of borrowers.

Physical Facilities

Bank interiors are gradually losing the cold and unfriendly architecture that typified them for many years. Modern instalment loan quarters are comfortable and provide the necessary facilities for confidential business.

Smaller banks using only their officers for handling instalment credit transactions sometimes are unable to provide privacy and comfort because of limited space and the need to be close to the bank lobby. Most larger banks are able to provide interview rooms or desks and, when necessary, conference rooms for transacting business with their customers.

Stationery Forms and Equipment

A large variety of accounting systems is available to banks. Almost all provide for some form of coupon payment book. Some smaller banks may use a passbook for entering customer payments, but these are much in the minority. The equipment ranges from complex mechanical or electronic machines to the simplest bookkeeping ones.

Legal documents, of course, are drawn up with the assistance of competent legal counsel. Credit statements, application forms, work sheets, and internal operating forms are usually designed to meet the operating requirements of each individual bank. While banks generally use

similar documents and forms, it is rare that such forms are identical in appearance or content.

Instalment Rates

Most instalment credit transactions are based on a specific amount of credit to be repaid in a stated number of monthly payments There are variations but they are largely confined to special situations While some banks discount a note at a desired rate, such a practice often results in the proceeds being a little greater or a little smaller than the amount requested to be financed The general practice is to add to the amount of the credit request the interest or finance charges, computed in terms of a certain number of dollars per year for each one hundred dollars borrowed. For example, a bank may loan a customer $100 for which it charges $6 per hundred per year If the loan were to be repaid in eighteen equal monthly instalments, the charge would be $6 for the first year and $3 for the additional six month period, making a total of $9 The customer would sign a note for $109, payable at the rate of $6 06 per month This rate is called an "add-on rate," since it is computed on the proceeds and added to them to determine the customer's total obligation This rate is sometimes quoted as 6 per cent interest or just 6 per cent, but this is a misstatement, this is not an interest rate and should never be so quoted by a bank This method of computation is widely used by banks and finance companies since it simplifies bookkeeping in that it eliminates the monthly computation of interest on a declining principal balance

A great many factors must be considered by a bank in establishing the rate it will charge for its instalment credit services. The rate on funds employed is important as it determines whether the dollar income produced on a given transaction is adequate in relation to the expenses involved in handling the transaction Consideration must be given to the cost of advertising, interviewing, credit investigation, and other operations incidental to acquiring an instalment credit transaction The cost of funds, collection costs, and administrative and overhead expenses also have an important bearing on rates

If it were possible accurately to determine the cost of each instalment transaction, it would theoretically be possible to make a charge that would assure a profit to the bank. However, there are so many variables that banks must set their rates according to the average cost for a particular class of business

The following simple formula is employed to estimate the rate of charge that will produce the yield a bank desires from each class of business.

$$C = \frac{(N + 1)\,Y}{2\,P}$$

C is charge desired for maturity specified.

N is the number of equal periodic payments on the note.

Y is the desired yield.

P is the number of payment periods in one year.

Take for example a two-year transaction on which a yield of 12 per cent is desired. The formula for arriving at the charge would be:

$$C = \frac{(24 + 1)\,12}{2 \times 12} \text{ or } C = \frac{300}{24} \text{ or } C = 12.50$$

Therefore, a charge of $12.50 for each $100.00 loaned will provide the bank a 12 per cent yield on a loan repayable in twenty-four equal monthly instalments. In some areas, service charges are permitted to offset partly the cost of acquisition to a bank. However, such charges are important mainly in connection with smaller loans on which interest charges alone are not adequate reimbursement to the bank.

More and more states regulate finance and loan charges by statute. Usury laws generally are applied to direct loan transactions. It is likely that charges on all forms of consumer credit will some day be universally regulated.

Service Charges and Fees

When legally permissible, the collection of service charges and fees helps defray the cost of making and collecting on instalment credit transactions. Some states permit lenders to charge an acquisition fee or at least to retain a minimum fee on any account that is paid in full a short time after the transaction was put on the books. The cost of filing or recording legal documents may often be passed on to the customer. The additional expense involved in collecting delinquent accounts may be partially recovered through late charges.

The assessment of additional charges has some unfavorable aspects in that it tends to disguise the true cost to the borrower. Some Congressmen have worked for legislation requiring full and complete disclosure of the costs involved in all types of credit transaction. Banks have generally established add-on rates, which can be simply quoted and easily understood by their customers. Obviously these rates must be adequate

to cover any special expenses when no fees are collected for them, thus, the cost of special attention is borne by all customers rather than only by those who require it.

In this particular matter, the policies of banks vary widely and for good reasons When statutes permit only a relatively low interest charge, it may be necessary, if the bank is to earn a reasonable return on its funds, to make such supplementary charges as the law will permit. Hence, on the subjects of interest, finance charges, and service charges, a banker in Illinois is likely to have problems completely different from those of one in Arizona

Credit Life and other Creditor Insurance

Many banks offer group creditors life insurance, accident and health insurance, or other forms of disability insurance in connection with instalment transactions In some cases the bank pays the premiums and in others the premiums are paid by the borrower or purchaser

The greatest value of these programs lies in the help they afford those suffering from death or disability, which results incidentally in good public relations for the bank After a death the widow or the estate of the deceased is relieved of the debt burden. Accident and health or disability insurance, depending on the terms of the policy, can afford welcome relief to a customer whom an accident or illness prevents from working

These forms of insurance are now closely regulated in many states. However, the banks offering such coverages are usually well informed of their responsibilities by the insurance carrier Under certain circumstances banks may receive experience dividends or rate credits from the insuror Depending on state and national banking laws, it is sometimes possible to secure a modest commission or compensation for services rendered in connection with the placing of group creditors' life and/or disability insurance Before accepting any such arrangements, banks are urged to examine carefully the legality of the proposals

Rebates

It has become an almost universal practice for banks to refund unearned time charges to customers who prepay their accounts Such prepayment rebates are usually based on the 'sum of the digits,' or '78ths,' method Figure 106 is an abbreviated form of a rebate chart which is

used by many banks and is based on the theory that in the first month a twelve-month loan would earn twelve times the amount that it would earn the last month. Adding the digits 12, 11, 10, and so forth through 1 totals 78—hence, the term "78ths" method. This method of computation applies to all loans that are to be repaid in equal monthly instalments and depends on the principal reductions being in equal amounts.

Figure 106 Rebate Chart

Multiply the Net Discount by the Proper Decimal as Shown In This Schedule.

The Result Is the Refund Allowance.

Months Contract Has to Run	NUMBER OF MONTHS IN CONTRACT																
	18	17	16	15	14	13	12	11	10	9	8	7	6	5	4	3	2
1	005	006	007	008	009	010	012	015	018	022	027	035	047	066	100	166	333
2	017	019	022	025	028	032	038	045	054	063	083	107	142	200	300	500	
3	035	039	044	050	057	065	076	090	109	133	166	214	285	400	600		
4	058	065	073	083	095	109	128	151	181	222	277	357	476	666			
5	087	098	110	125	142	164	192	227	272	333	416	535	714				
6	122	137	154	175	200	230	269	318	381	466	583	750					
7	163	183	205	233	266	307	358	424	509	622	777						
8	210	235	264	300	342	395	461	545	654	800							
9	263	294	330	375	428	494	576	681	818								
10	321	359	404	458	523	604	705	833									
11	385	431	485	550	628	725	846										
12	456	509	573	650	742	857											
13	532	594	669	758	866												
14	614	686	772	875													
15	701	784	882														
16	795	888															
17	894																

The method of computing charges on irregular payment loans determines the formula to be used in computing rebates on them. If each instalment specifies the amount of interest and principal to be paid, the task is simple. However, if the interest is averaged so as to make the periodic payments equal, even though they are not paid monthly, the rebate computation is a little more complex.

Dealer Plans

A wide variety of arrangements is possible in connection with the purchase of instalment sale paper from dealers.

1 *Full Recourse* Under this plan the dealer unconditionally guaranties all paper sold to the bank, and if his guaranty is supported by an excellent financial condition, he will generally obtain the bank's lowest discount rate

2 *Limited Recourse* The dealer may agree to guaranty each contract sold for a short period of time with the provision that in the event the customer defaults on the payment of his obligation during the period specified, the dealer remains liable for the full term of the contract.

3 *Recourse to Reserves* A portion of the total time charges is placed in a reserve account when a transaction is purchased from the dealer Any losses that subsequently occur are charged to the reserve account, but should the account be depleted, the bank has no further recourse to the dealer When reserves accumulate to an amount greater than required under the agreement with the dealer, any excess is remitted to the dealer

4 *Repurchase* Generally this type of plan provides that when an account is in default, the dealer will repurchase the merchandise involved if tendered to him within the ninety-day period following the date of the earliest unpaid instalment This places the obligation of locating and repossessing the merchandise on the bank Sometimes arrangements specify that a dealer will repurchase a defaulted contract within a specified period without regard to the tender of merchandise, thus placing the burden of locating and repossessing on the dealer This is simply a full-recourse plan except that the liabilities are contingent upon a default existing for a certain period of time

5 *Non Recourse* Paper purchased from dealers under this plan bears only the usual warranties, such as genuineness and legality, that any assignment for value implies In the absence of any dealer liability or reserves, the bank obviously must select the paper carefully, the prime consideration being the credit qualifications of the purchaser

Almost without exception, plans involving some liability on the part of the dealer include provisions for supporting the liability with some form of loss reserve These reserves are generally accumulated by taking a portion of the time charge or part of the proceeds due the dealer and placing them in a reserve, or holdback, account which is to stand as a guaranty for the obligations of the dealer to the bank In situations where a dealer cannot comply with the terms of his agreement, losses may be charged to the reserve account

There are many variations of the basic plans described above, including distributor or factory-sponsored arrangements, non notification plans,

and bulk purchase plans. For the purpose of this chapter, the brief descriptions of dealer plans are confined to those most generally in use. The terms and conditions under which paper is purchased from dealers are incorporated in a written form of dealer agreement.

Figure 107A Survey Made by Instalment Credit Commission of the American Bankers Association (*front*)

INSTALMENT CREDIT COMMISSION
AMERICAN BANKERS ASSOCIATION

Composite results of questionnaire on instalment credit received from 340 outstanding commercial banks engaged in this field of lending Based on statistics as of December 31, 1959

1 Percentage representing each class of instalment credit in an instalment loan portfolio

CLASS OF LOANS	NUMBER	DOLLAR AMOUNT	GROSS INCOME	AVERAGE LOAN
Personal Loans	23 80%	14 19%	15 78%	$ 502
F H A Title I	12 28%	10 43%	10 23%	$ 897
Modernization–Own Plan	8 36%	6 71%	6 95%	$ 863
Automobile–Direct	12 80%	18 37%	18 19%	$1,372
Automobile–Indirect	16 22%	23 68%	20 78%	$1,529
Appliances	14 39%	6 27%	7 57%	$ 395
Mobile Home	2 61%	7 14%	7 20%	$3,097
All Other Instalment–Retail	9 54%	13 21%	13 30%	$2,137
Total	100 00%	100 00%	100 00%	

2 Percentage of total deposits invested in instalment credit outstandings

TOTAL DEPOSITS (In millions)

Up to $10	*$10-25*	*$25 50*	*$50 100*	*Over $100*
15 32%	*15 53%*	*13 46%*	*10 63%*	*9 15%*

3 Ratio of total instalment credit outstanding to total loans and discounts, including mortgages, not including investments

TOTAL LOANS AND DISCOUNTS (In millions)

Up to $10	$10-25	$25 50	$50-100	Over $100
37 18%	26 34%	21 41%	20 96%	15 27%

4 Ratio of gross instalment credit income to gross income from total loans and discounts, including mortgages, not including investments

TOTAL LOANS AND DISCOUNTS (In millions)

Up to $10	$10-25	$25 50	$50-100	Over $100
43 17%	37 98%	34 03%	30 66%	23 81%

5 Ratio of gross instalment credit income to outstandings 8 86%

6 Ratio of gross instalment credit expense to outstandings 3 08%

7 Ratio of net income to outstandings (5 minus 6) 5 78%

8 Ratio of total instalment credit expense to gross instalment credit income . 34 76%

Figure 107B Survey Made by Instalment Credit Commission of the American Bankers Association (*reverse*)

9 Number of instalment loans delinquent 30 days or more expressed as a percentage of total instalment loans outstanding as of December 31, 1959 1.66%

10 Number of instalment loans outstanding per employee 525

11 Current Terms

A)

	Most Common Down Payment	Most Common Term	Average Term	Range
Appliance–White Goods	10%	24 mos	20 mos	18–36 mos
Television	10%	24 mos	20 mos	18–36 mos
Furniture	10%	24 mos	20 mos	18–36 mos
Food Freezers	10%	24 mos	23 mos	18–36 mos
Boats – New	25%	24 mos	24 mos	12–60 mos
Used	33%	24 mos	19 mos	12–36 mos
Mobile Homes – New	25%	60 mos	52 mos	24–84 mos
Used	33%	48 mos	37 mos	12–72 mos
Modernization – Own Plan		60 mos	33 mos	24–60 mos
F H A Title I		60 mos	36 mos	36–60 mos

B)

	DIRECT			INDIRECT		
Automobiles	Most Common Term	Average Term	Range	Most Common Term	Average Term	Range
1960 New (full size)	36 mos	30 mos	24–36 mos	36 mos	32 mos	24–36 mos
1960 New (economy)	36 mos	29 mos	24–36 mos	36 mos	31 mos	24–36 mos
1960 Used	30 mos	27 mos	24–36 mos	30 mos	29 mos	24–36 mos
1959	24 mos	24 mos	18–36 mos	30 mos	26 mos	24–36 mos
1958	24 mos	21 mos	18–36 mos	24 mos	23 mos	18–36 mos
1957	24 mos	19 mos	12–36 mos	24 mos	20 mos	12–36 mos
1956	18 mos	16 mos	12–24 mos	18 mos	18 mos	12–24 mos
1955	18 mos	14 mos	12–24 mos	18 mos	15 mos	12–24 mos
Foreign New	36 mos	28 mos	24–36 mos	36 mos	30 mos	24–36 mos

C) Percentage of new car paper financed for periods in excess of 30 months

DIRECT

12% of the banks reported they had *no* direct paper on new cars with terms in excess of 30 months. The remaining banks in this group indicated that an average of 53% of their direct new car paper was for terms in excess of 30 months.

INDIRECT

4% of the banks reported they had *no* indirect paper on new cars with terms in excess of 30 months. The remaining banks in this group indicated that an average of 70% of their indirect new car paper was for terms in excess of 30 months.

D) Retail advance on new cars most commonly related to a percentage of dealer's wholesale cost

Advance is 90 – 100%

EXPERIENCE RECORD OF INSTALMENT CREDIT IN BANKS

It is necessary to generalize when discussing the experience of banks in the instalment credit field. There probably are no two banks having situations identical enough to warrant comparisons. However, on the basis of surveys made from time to time by the Instalment Credit Com-

mission of the American Bankers Association, it seems safe to observe that the instalment credit experience of most banks has been good. Loss ratios in the period after World War II have been abnormally low even through the mild recession periods. This is to be expected in a growing and expanding economy. However, the prudent bank has been building *reserves against the time* when losses run into more substantial figures. When that may be cannot be foreseen, but as long as peaks and valleys exist in our economy, provision for contingencies is just good insurance.

Instalment credit is not an exact science because it involves human judgment and factors beyond the control of both borrower and lender. The business, therefore, must be judged on its over-all record. Perhaps the best source of such information is the survey made by the Instalment Credit Commission of the American Bankers Association covering the situations of reporting banks on December 31, 1959 (see Figures 107A and 107B).

The information is interesting and may provide a fair yardstick for a bank to use in determining its experience in relation to that of other banks of similar size. It must be remembered, however, that the statistics relating to costs cannot possibly be based on uniform cost-accounting methods, so that these statistics should not be accepted at face value. Gross yields are stated in terms of the ratio of income to outstandings, *which does not give consideration to the fact that unearned discount and* dealer reserves reduce the bank's actual investment and may increase the gross yield by as much as 10 per cent.

Other interesting trend studies may be found in the annual publication of the National Instalment Credit Conference Proceedings. Loss studies are not available, but it is rare to find a bank that has a loss to liquidation ratio of more than one half of 1 per cent. Many losses are absorbed by dealer reserves and, therefore, are not reflected in the loss record of the bank.

One of the most useful reports is the monthly bulletin issued by the Instalment Credit Commission of the American Bankers Association covering delinquency rates on bank instalment loans by type. This provides an excellent means of measuring the portfolio quality and collection efficiency of a bank.

OPERATING PROCEDURES

Each of the following procedures is an important link in the chain of a successful operation—and, as the saying goes, "a chain is no stronger

than its weakest link" Naturally, in smaller banks many of these jobs will be performed by one person

Credit Interview

The primary purpose of a credit interview is to determine the applicant's or the purchaser's credit qualifications Direct loan interviews are made by a member of the bank's staff, while credit information on paper offered for purchase by dealers is secured by the dealer's salesman The bank's lending officer or interviewer should have a clear understanding of the bank's loaning policies and credit standards so that obviously unqualified applicants can be screened out This is done with the assistance of an application form (Figure 108) which calls for the personal information that becomes the basis for the credit investigation and the credit decision The credit application form used by dealers is usually somewhat less comprehensive (Figures 109A and 109B)

Dealer salesmen are not always good credit interviewers and generally get a minimum of information This places the burden of checking an applicant's qualifications on the credit investigation

The bank's credit interviewer will first establish the identity of the applicant, each bank has its own rules about identification He then proceeds to secure the information required in the application, in a conversational manner and with a positive attitude about the applicant's prospects of qualifying for the loan In fact, there is no means of qualifying or disqualifying other than getting all the necessary facts When the interview is completed and if the applicant's request appears to warrant consideration, the application is ready for credit investigation

At this point it should be observed that the information furnished by the applicant has not been verified, so that to make a credit decision immediately would be premature and unwise

Credit Investigation

Using as a basis for investigation the credit statement secured by the interviewer or the information telephoned by the dealer's salesman, the credit investigator proceeds to make inquiries designed to substantiate or refute such information The objectives of the investigation may be stated as follows

1 To establish that the applicant is a good moral risk.

2 To verify the amount of the applicant's income and, if possible, the stability of his employment and employer

3. To determine the applicant's record of meeting his obligations elsewhere.

4. To verify to the extent deemed desirable the applicant's age, marital status, length of residence, and other salient points.

The investigation can be made in a variety of ways. The fastest is to

Figure 108 Application for Instalment Credit

TO FIRST WISCONSIN NATIONAL BANK OF MILWAUKEE

Net Amount $

No of Months

The undersigned hereby makes application for a loan The proceeds of the loan will be used for the following purpose

PRINT FULL NAME ______ Telephone Number ______ Years in this city ______

Address ______ (City) ______ Years at this address ______

Previous address ______ (City) ______ Years at this address ______

Age ______ Married ☐ Single ☐ Widowed ☐ Divorced ☐ Separated ☐ Wife s or husband s name ______ Number of other dependents ______

EMPLOYER OR FIRM NAME ______ Address ______ Telephone ______

Kind of business ______ Badge number or superior s name ______

How long there ______ Position or occupation ______ Monthly income after withholding taxes $ ______

Previous Employer ______ Occupation ______ How long ______

WIFE or husband Employed by ______ Address ______ Telephone ______

Kind of business ______ Badge number or superior s name ______

How long there ______ Position or occupation ______ Monthly income after withholding taxes $ ______

OTHER INCOME (Specify source) ______ Amount per month $ ______

CHECK ONE Home owner ☐ Buying home on land contract ☐ Rent un furnished ☐ Rent furnished ☐ Board ☐

Mortgage land contract or rent payments made to ______ Amount per month $ ______

Date home was purchased ______ Original cost $ ______ Present Balance $ ______

Year and make of automobile owned ______ Financed by ______

Your bank ______ Checking $ ______ Savings $ ______ Loan $ ______

Your credit union ______ Amount on deposit $ ______ Loan balance $ ______

Amount of life insurance carried $ ______ If you have ever gone through bankruptcy state year ______

Are there or have there ever been any judgments garnishments or other legal proceedings on record against you? ______

NAME and ADDRESS of close friend or relative not residing with you ______

PRESENT OBLIGATIONS List all amounts you now owe including installment purchases loans, charge accounts and other indebtedness

OWED TO (NAME AND ADDRESS)	AMOUNT OWED	MONTHLY PAYMENTS

Other credit references

DRAFT CLASSIFICATION	DATE OF CLASSIFICATION	PAY DAY OR DATES	AUTOMOBILE LICENSE NO

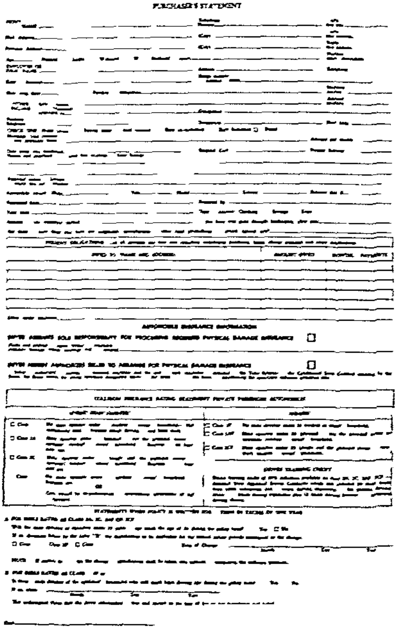
The undersigned hereby certifies that all of the statements made in this application are true and complete and are made for the purpose of obtaining a loan. You may secure any information you require concerning statements made herein and this application shall at all times remain your property

Date ______ Applicant s signature ______

F696—8-1 54

make a series of telephone calls. This method, of course, requires specially trained personnel, who can tactfully learn the information without embarrassing the applicant. Many banks prefer to use credit reporting agencies to get the benefit of any information on the applicant they may already have in their files. Sometimes a combination of reporting agency

Figure 109A Credit Application Form Used by Dealers
(*front*)



and direct checking information produces excellent results. Independent checking of judgment, lien, and chattel mortgage recording is done by some banks. However, there is a practical limit to the amount of time and money that should be spent for credit investigation. Naturally the

Figure 109B Credit Application Form Used by Dealers (*reverse*)

DEALER'S WORK SHEET

SEND ORIGINAL, DUPLICATE AND TRIPLICATE COPIES OF CONTRACT AND THIS FORM TO FIRST WISCONSIN NATIONAL BANK OF MILWAUKEE

NEW OR USED	YEAR MODEL	NO. CYL.	MAKE TRADE NAME	BODY STYLE (If Truck, Tons Capacity)	MODEL LETTER OR NUMBER	MANUFACTURER'S SERIAL NUMBER	MOTOR NUMBER

☐ Automatic Transmission ☐ Radio ☐ Heater ☐ Power Steering ☐ Power Brakes ☐ Air Conditioning ☐

1 CASH SALE PRICE $ ______

2 DOWN PAYMENT CASH $ ______ NET TRADE IN CREDIT $ ______ TOTAL DOWN PAYMENT $ ______

TRADE-IN YEAR ______ MAKE ______ MODEL ______

3 UNPAID CASH PRICE $ ______

4 AUTOMOBILE INSURANCE PREMIUM FOR ______ MONTHS (SYMBOL ______)

☐ COMPREHENSIVE (ACV) ☐ $ ______ DEDUCTIBLE COLLISION (ACV)

☐ FIRE THEFT AND COMBINED ADDITIONAL COVERAGE (ACV) ☐ ______

5 ______ $ ______

6 TOTAL OF ITEMS 3 4 AND 5 $ ______

7 ______ $ ______

8 ENTER INSURANCE CHARGES HERE ONLY WHEN COVERAGE IS TO BE PURCHASED BY BANK.) LIFE INSURANCE CHARGE $ ______) DISABILITY INSURANCE CHARGE $ ______

9 UNPAID BALANCE TO BE FINANCED (TOTAL OF ITEMS 6 7 AND 8 $ ______

10 TIME PRICE DIFFERENTIAL $ ______

11 TIME BALANCE $ ______

PAYABLE IN ______ MONTHLY INSTALLMENTS OF $ ______ BEGINNING ______

USE THIS SPACE FOR CALCULATIONS IF CHART FIGURES ARE TO BE COMBINED	AMOUNT FINANCED (ITEM 6)	CREDIT LIFE INS. PREM. (7)	PERM. TOTAL DIS. INS. PREM. (8)	TIME PRICE DIFF. (10)	TIME BALANCE (11)	MONTHLY PAYMENTS
TOTALS						

F 1108—8 21 59

DO NOT WRITE IN THIS SPACE

bank should check its own records for account relationships and past credit experiences with the applicant.

Because of the competitive nature of instalment credit, the objective of the investigator should be to get the most accurate and complete information in the shortest possible time. After this is done, the credit application and the results of the investigation are referred to the officer or credit manager for approval.

Credit Approval

The committee system may work well for large commercial loans, but instalment credit transactions require prompt decisions, especially if

dealers are involved The extent to which this authority is delegated to individual officers is a matter for each bank to decide Some limit the dollar amount of credit an officer may grant. Others limit him to a specific type of loan

In any case the credit manager or officer must make an objective analysis of the following points

1 Is the applicant a good moral risk? If the investigation reveals deliberate misstatements by the applicant, conviction for criminal offenses, embezzlement, moral turpitude, or other indications of poor moral character, the application is usually rejected without further consideration However, only a negligible number of applicants need be disqualified for these reasons

2 Is the accuracy of the applicant s statements substantially verified? Minor deviations in the amount of indebtedness or income should not be considered material Grossly inaccurate statements, though they may not have been made with intent to mislead, nonetheless are not conducive to confidence in the applicant.

3 Does the applicant have sufficient income to repay the loan? Since it is impossible and impractical to analyze each applicant's budget in detail, it is necessary to make the appraisal of his ability to repay the credit by evaluating the factors of dependency, shelter payments, fixed expenses, life insurance program, take home pay, and other items listed in the credit statement. In this connection there probably is no substitute for experience gained in reviewing many, many credit statements

4 Is it logical to assume that the applicant s employment or source of income is reasonably permanent? The applicant who changes jobs frequently is less likely to be as good a risk as the one who has gained a good seniority rating in a well-established organization The stability of the employer and the size of his business are also important factors to consider While it is unfair to single out any particular type of employment as an undesirable credit factor, it nevertheless appears to be well documented that credit extended to individuals employed in certain professions or jobs involves a greater than average risk

5 Has the applicant established a satisfactory record of paying his obligations promptly? This is one of the most important factors in extending instalment credit The person who is lax in paying bills when due may be credit worthy in other respects, but a bank cannot afford knowingly to acquire collection problems since collection costs are one of the major expenses of operation.

6 Does the loan serve a constructive purpose? If a cash loan, will it

really do the job of adjusting a debt problem or conveniently budget lump-sum expenses? If an instalment purchase, is the obligation manageable, and has the purchaser used good judgment in so obligating himself?

7. How much weight should be given to the factors of age, length of residence, financial resources, and home ownership?

8. If the transaction is being purchased from a dealer, how much should the volume of business purchased from the dealer, the experience record on the paper, the extent of the dealer's liability, the amount of reserves held, and the ability of the dealer to perform his obligations be allowed to influence the credit decision? Generally, credit standards on dealer transactions are not rigid.

Attempts have been made in a few banks to establish a grading system under which each credit factor is assigned a number of points. These, when totaled, should be a guide either to approval or to rejection. No credit-selection system is foolproof, and a grading plan has its shortcomings in that the intangible factors cannot be weighed. There is no substitute for good judgment exercised by experienced and competent people.

Completing the Transaction

Approximately eight out of ten applications for credit will be approved by the credit officer. This is a fair average, but if no screening is done at the interview level, the ratio will be lower.

Dealers and customers should be notified of the credit decision as soon as possible. In the case of direct loans, the transaction is completed by having the borrower, and often his wife, sign an instalment note (Figures 110A and 110B) and whatever security documents may be required in connection with the loan. Chattel mortgages are probably used more frequently than any other form of security instrument.

After the necessary documents are completed, the proceeds of the loan are paid to the borrower in the form of a check or credit to his account. They are sometimes paid directly to his creditors; and in the case of an instalment purchase transaction, they may be paid to the seller of the merchandise. If the proceeds are paid to anyone other than the borrower, it is general practice to secure from the borrower an authorization to do so.

On dealer transactions, the documentation is completed by the dealer. In a great many states, conditional sale contract forms are used. The rights

of buyers, sellers, and assignees under such contracts are most usually delineated in a statute. The form and content of certain provisions of a conditional sale contract may also be prescribed by law. In addition, a full disclosure of the cash selling price of the article, cash down payment, description of trade in and allowance therefor, finance charges, time balance, insurance charges, description of insurance coverages, and

Figure 110A Instalment Note (*front*)

TCD No.________ Milwaukee, Wis. ________ $________

FOR VALUE RECEIVED the undersigned promises to pay to the order of
FIRST WISCONSIN NATIONAL BANK OF MILWAUKEE, (hereinafter called the "Bank") at any of its offices in the City of Milwaukee, Wisconsin, the sum of ________ Dollars, which includes interest $______, service charge $______, life insurance charge $______ and disability insurance charge $______ in installments as indicated in the Schedule of Installments on the reverse side hereof or if such schedule is not completed, then in ______ installments as follows: $______ on ______ 1☐ 7☐ 3☐ 6☐ 20☐ 25☐ 19____ and an equal amount at consecutive monthly intervals thereafter (except that the final installment may be more or less, being the amount necessary to complete the total sum due hereunder) until the full amount of said note shall have been paid.

The nonpayment of any installment of this note at the time and place specified herein shall, at the option of the Bank, render the entire unpaid balance of this note, less any unearned interest and service charges, due and payable forthwith, without any notice whatsoever, which unpaid balance shall bear interest at the rate of [illegible] per cent per annum from due date thereof.

To secure the payment of this note, the undersigned authorizes irrevocably any attorney of any court of record to appear for the undersigned in such court in term time or vacation at any time after this note is due, either through lapse of time or acceleration, as herein provided, and confess a judgment without process in favor of the holder hereof for such amount as may be due on this note, together with costs and attorney fees of ten per cent on the balance due, and to waive and release all errors which may intervene in any such proceedings, and consent to immediate execution upon such judgment. The undersigned hereby ratifies and confirms all that said attorney may do by virtue hereof.

The undersigned and each endorser hereby waives presentment, demand, notice of dishonor and protest, and consents to any and all extensions hereof without notice thereof. The undersigned, if more than one, shall be jointly and severally liable hereunder and all provisions hereof shall apply jointly and severally to the undersigned, if more than one.

The Bank is hereby authorized by the undersigned without notice to the undersigned to date this note as of the day when the disbursement of the loan evidenced hereby is made and to fill in the date on which the initial installment will become due.

Address________________ ________________(SEAL)

Address________________ ________________(SEAL)

[illegible]

Figure 110B Instalment Note (*reverse*)

SCHEDULE OF INSTALLMENTS

$____ on ____ 19____	$____ on ____ 19____
$____ on ____ 19____	$____ on ____ 19____
$____ on ____ 19____	$____ on ____ 19____
$____ on ____ 19____	$____ on ____ 19____
$____ on ____ 19____	$____ on ____ 19____
$____ on ____ 19____	$____ on ____ 19____
$____ on ____ 19____	$____ on ____ 19____
$____ on ____ 19____	$____ on ____ 19____
$____ on ____ 19____	$____ on ____ 19____
$____ on ____ 19____	$____ on ____ 19____
$____ on ____ 19____	$____ on ____ 19____
$____ on ____ 19____	$____ on ____ 19____
$____ on ____ 19____	$____ on ____ 19____
$____ on ____ 19____	$____ on ____ 19____
$____ on ____ 19____	$____ on ____ 19____
$____ on ____ 19____	$____ on ____ 19____
$____ on ____ 19____	$____ on ____ 19____
$____ on ____ 19____	$____ on ____ 19____

the amount and due date of payments may be required, particularly in connection with automobile transactions.

Usually a contract covering the sale of merchandise on a time basis is prepared in triplicate; the original signed copy is sent to the bank for purchase. The second or third copy is given to the purchaser of the merchandise, which is mandatory in most states. The remaining copy is retained by the dealer for his records. Payment by the bank may be made by a credit to the dealer's account, by payment of a sight draft drawn on the bank by the dealer, or by a cashier's check.

Discounting

This procedure provides certain checks and balances, particularly on dealer paper. It is the discount teller's duty to determine that the transaction has been approved for purchase and that all conditions have been fulfilled. He will then examine the documents to verify that they are properly drawn and signed and are legally enforceable. The calculation of charges and monthly payments is checked, and the dignity of the bank's lien on personal property being pledged or purchased is established.

Billing

After the discount teller has checked the transaction, it is ready to be set up on the bank's books. The total amount of the note or contract will be charged to loans and discounts and will be offset by credits to official checks or a customer's account, unearned discount charges, dealer reserves or holdbacks, group life insurance premiums, and other accounts.

The billing operation consists of the preparation of a coupon book, ledger card, index cards, accrual records, customer letter, dealer acknowledgment, and whatever other records a bank may require for servicing an account. Sometimes these records are typed individually, but most banks attempt to produce two or more of them in a single writing. Multiple-copy forms or duplicator systems are commonly used for this purpose. It is wise to limit the amount of information in each record to such details as will serve a definite purpose. The bank records are distributed to the department in which they will be used, and the coupon book and letter of transmittal are forwarded by mail to the customer. If a recordable security document is involved in the transaction, it should be filed promptly to perfect the lien. Some banks prefer purchasing non-

filing insurance, rather than perfecting their lien as provided by law. Failure to file or record usually does not affect the secured status of the lender until bankruptcy or other creditor claims arise.

Ledger Records

It is a fairly standard practice to number accounts consecutively within a classification and to file ledger cards by due date, then account number. This makes it easy to scan for delinquent accounts, and of course, numerical accounting is more efficient than alphabetical accounting when large numbers of accounts are involved.

As payments are received from customers, they are sorted by classification, due date, and account number. When the payment is represented by a coupon, this is a simple operation If a passbook is used in connection with posting at a window, usually no posting media is secured.

There are a number of different methods of maintaining ledger records and posting payments. However, the actual accounting is a simple bookkeeping operation requiring no detailed description.

Income Accrual

The banks that operate on a cash basis take discount and interest charges into income immediately. Banks on an accrual basis are faced with the task of selecting a method of computing earned income which will either duplicate or closely approximate the true earnings on their instalment credit portfolio. This is not an easy task, since loans do not have a common due date or identical yields The best that can be done under the circumstances is select a method that will yield a fairly accurate result, and then make the periodic adjustments necessary to have an adequate reserve for unearned discount.

Accrual methods include the average interest, the level accrual, and the 78ths, or sum of the digits, methods. Each can be fairly accurate. The bank requiring very accurate results will find that they involve considerable effort.

Collection Procedures

While instalment credit transactions are made with the expectation that they will be repaid on schedule, unforeseen contingencies and other factors may make some type of collection action necessary on possibly 10 per cent of the accounts. This action ranges from a simple and polite reminder

notice to legal action. Experience has shown that sending out a past-due notice on the day following the due date of an unpaid instalment is an unwise and unnecessary expense. Most banks give a customer a grace period of one week before sending a reminder. Some wait as long as ten days to two weeks before calling the default to the customer's attention. However, if the payment remains past due after twenty days, collection efforts are personalized. This is done by letter, telephone call, or a visit to the customer at his home or place of business. The best results are obtained by close follow-up on delinquent accounts. The bank's efforts are aimed at getting to the root of the customer's difficulty and assisting him in finding a solution to the problem. Relatively few customers will be completely uncooperative, so that strong collection measures are seldom necessary.

When strong measures are required to enforce payment of the debt, they may be in the form of legal action or of repossession and sale of the commodity financed or pledged to the account. The primary purposes of collection action are to reinstate the account, retain it as an income-producing asset, retain the customer's good will, and avoid further collection expenses.

Charged-off loans should be given as much collection attention as those in default a shorter period of time. There sometimes is a tendency to relax collection efforts once a loan is charged to loss reserves. Since many banks are required to charge off any loan on which the earliest unpaid instalment is over ninety days past due, many ultimately collectible accounts are in the charged-off category.

Protective and Control Measures

Instalment financing and dealer sales financing in particular involve some hazards to the bank other than the credit risks. Fictitious paper, undelivered merchandise, duplicating financing, misappropriation of payments, and misrepresentation are a few of the ways in which a bank may be defrauded. Undetected, any one of these conditions may build up to a point where sizable losses could be incurred. Such losses can conceivably exceed the credit losses for an entire year.

To minimize the possibility of such types of fraud, it is recommended that notice of purchase of an account from a dealer be mailed directly to the customer. In addition, a certain number of the customers should be called on to verify the transaction. This is called "spot-checking" and may be done by telephone and letter as well as in person.

Periodically the bank s auditing department should request a certain percentage of customers to verify the unpaid balances on their accounts. It is also healthy to make dealers aware that checking is done on a regular and systematic basis by calling customer s complaints to their attention whenever the opportunity exists Protective measures should also be taken in connection with direct loans to assure officer and employee fidelity

SPECIAL FORMS OF CONSUMER INSTALMENT CREDIT

Instalment credit is a subject so comprehensive that it is possible only to scratch the surface within the space of a chapter Entire books have been written on single phases of instalment credit It is a business within a business whose administration requires considerable ability

Some of the facets of the business that have not been touched on are such services as tuition plans bank agent financing lease financing floor plan financing instalment loans to small businesses commercial and industrial equipment financing and the financing of a wide variety of services A chapter or more could be devoted to each However there are two relatively new forms of instalment and consumer credit that have created a great deal of interest. These are the check credit plan and charge account banking At the current stage of their development it is not possible to predict whether these plans will take their place beside the well established forms of consumer credit

Check Credit Plan

This unique form of instalment credit was introduced by the First National Bank of Boston in February 1955 Credit for its development is due Mr Roger Damon now president and chairman of the executive committee of that bank

While the announcement of this new plan immediately created widespread interest, it was not until early 1959 that any substantial number of banks adopted the check credit plan or variations of it There probably were two factors that influenced these banks to offer the service First, the plan appeared to have merit as a profitable form of instalment credit and second it provided an opportunity for the aggressive promotion of a new idea The first bank to introduce this plan in its community was credited with being alert, aggressive and dynamic

The plan itself is rather simple in operation The customer fills out an application form for a certain maximum amount of credit he desires to

have available to him. This generally is in multiples of a specified maximum monthly amount which the customer feels he can pay conveniently. Some banks limit the maximum credit to twelve times the monthly payment, while others establish the maximum at twenty or twenty-four times the amount. Another variation provides for payments to be a certain fraction—one twelfth or one twentieth—of the balance owed by the customer on the statement date.

When the credit is approved, the customer signs a "check credit agreement" and is supplied with ten or fifteen checks, a check wallet, a change of address slip, a check register, a reorder form, and a written advice of the amount of the line of credit established for him. The checks generally have no special identification other than a sorting code recognized only by the bank.

In effect, the arrangement constitutes a line of credit, and as a customer makes his monthly payments, the amount repaid serves to increase the amount of unused credit available to him. Obviously this form of credit is most safely extended to individuals having better than average credit qualifications. Probably the most important qualification is the ability of the customer to manage his financial affairs on a sound basis. For this reason the advertising and promotional media are often selected to appeal to a specific group of borrowers. Broad promotion programs are likely to develop excessive rejection ratios.

Checks drawn against the available credit are charged to the customer's check credit account. This reduces the available credit, and when the bank pays the check it constitutes a loan. The loan balance draws interest at the rate specified in the agreement and is subject to state statutes governing interest rates. When permissible, some banks make a charge of twenty-five cents for each check paid. Interest is computed on average daily balances in most cases, but some banks are able to compute the charge on the balance owed on either the statement date or some other fixed date. No charge is made until the account is used.

Statements are mailed to a customer from one week to fifteen days prior to the date on which he is required to make his payment. If payments become overdue, the normal collection procedures are employed. It is also advisable to review accounts periodically to determine whether the customer is making proper use of the credit. Stop payments and overdrafts are involved at times, and in many ways the accounting operation is similar to checking account operations. The bookkeeping, however, is somewhat more complex because of the interest computation and the necessity of maintaining a record of the balance of unused credit.

Check credit plans are known by many names and have a number of variations One calls for use of the customer's regular checking account and standard check form. In this case the customer does not draw a check against his line of credit but instead sends a request to the bank to transfer a certain portion of the available credit to his checking account The authorization to make the transfer then creates the loan In most other respects the arrangements are similar to the standard check credit plan

Regardless of the name or form of this credit, the basic purpose is to make credit more conveniently available to customers This plan in theory reduces the cost of making loans, but this advantage is somewhat offset by the added cost of servicing Each bank should carefully weigh the pros and cons before establishing a service of this kind In the final analysis it will be the consumer who determines the importance of this service in the consumer credit field

Charge Account Banking

"Charge it, please"

For many years purchasers were able to say this only at larger stores that had the resources, personnel, and know-how necessary to operate a credit department Now smaller merchants in many sections of the country can offer a charge account service as the result of the entry of a number of banks into the field of charge account banking

The plan which is currently being offered by more than one hundred banks, including especially the Bank of America, was organized by the Franklin National Bank of Franklin Square, New York In essence the service is identical to the conventional charge account arrangement available at most large department stores This includes the revolving credit feature which has been widely adopted Under the latter plan the customer pays a service charge of up to 1½ per cent per month on any balance remaining unpaid on the due date of the charge account The due date is generally twenty five days after the statement's closing date so the customer incurs no service charge from the date of his purchase until the account converts automatically to a revolving credit The customer then has the option of paying one sixth, one tenth, or some other fraction of the balance each month

A bank entering the charge account banking field controls credit approval and all other phases of the arrangement Credit cards are issued t

customers upon approval of credit applications. Merchants who qualify are furnished sales drafts, deposit envelopes, imprinters, operating manuals, and other necessary items.

When the customer wishes to charge a purchase, he produces the credit card issued to him. The sales slip is prepared by the merchant and signed by the customer. Generally the merchant is required to secure credit approval of the transaction from the bank, except in those cases where the purchase is less than the automatically authorized credit, which is sometimes encoded on the credit card or may be established by agreement with the merchant.

The purchaser's signature on the sales slip creates the necessary evidence of indebtedness, which the bank purchases from the merchant at a discount—generally 94 per cent of the amount of the sale. Merchants may qualify for refunds based on volume and amount of the average sale. These refunds may reduce the discount cost to as little as 3 per cent. Usually the merchant places the sales slip in an envelope on which the net proceeds are computed. This amount is listed on a deposit slip, and the sales slip is deposited for credit to the merchant's account.

A written agreement between the merchant and the bank describes the terms and conditions under which the plan is made available to the merchant and his customers. Items such as rental of imprinters, rates of discount, refunds, adjustments, purchase of drafts, and collection of accounts are covered in detail.

In contrast to check credit plans, the establishing of a charge account banking service is fairly expensive. Advertising, solicitation of merchants, forms, imprinters, credit cards, specialized equipment, operating manuals, and other items require a substantial investment of time and money. In addition, the service must be available during the hours the merchants are open for business.

Theoretically a bank can take over the function of a merchant's credit department and operate it more economically than the merchant. The bank's cost of funds is lower, and it may be able to achieve lower unit costs through modern accounting procedures, whose cost would be prohibitive for a small merchant.

Aside from the potential for profit, the greatest benefit to banks appears to be in the acquisition of new customers and the establishment of a banking relationship with merchants who are required to become customers to qualify for the service. One of the objectives of banks entering this field is to attract deposit accounts from merchants, which would

provide most or all of the funds employed in the charge account banking operation Merchants, of course, benefit to the extent that every holder of a bank's charge card is a potential customer

While this form of bank consumer credit has been in existence for ten years, the reports and statistics furnished by participating banks on the profitability of the service are inconclusive Most banks reporting consider the collateral benefits to be of significant, though not measurable value

Regardless of its form or its name, all instalment credit is based on the same fundamental principles These are the character of the obligor and his ability and willingness to perform his obligations

For the guidance of banks the Instalment Credit Commission of the American Bankers Association has formulated the following instalment credit creed and standards of practice Banks embracing these principles will earn the good will, respect, and support of the general public

INSTALMENT CREDIT CREED

We believe, that in order to justify its charter, a bank should serve the reasonable credit requirements of its community, as well as provide a safe depository for funds

That the extension of instalment credit to individuals and small business on a sound basis is an economically important part of such service

That banks, by the extension of instalment credit, facilitate the distribution of goods, and help people meet emergencies, take advantage of opportunities and improve their standard of living

That although a bank must be competitive, it should maintain its policies and practices on a basis that will insure continued public confidence

That a bank has a responsibility to assist its customers to use their credit wisely

That while recognizing the importance of volume, banks should keep all advertising truthful, restrained, and exact

That a bank in purchasing instalment paper from dealers should maintain reasonable rates to the public and the same fair policies accorded to all other customers

That banks should require that each customer be fully informed of all charges in connection with an instalment credit transaction

And, finally, that all banks extending instalment credit on these principles will merit the good will and the support of the people

INSTALMENT CREDIT STANDARDS OF PRACTICE

The foundation for the extension of instalment credit is the integrity and earning power of the American people Banks should extend instalment credit selectively on the basis of character and ability to repay

While the use of protective devices may minimize the risk in extending the credit, such devices are supplemental rather than basic

Banks should establish and maintain sound terms in relation to existing economic conditions. Unusually long terms, skip payments, low or no down-payment plans should be discouraged.

Balloon notes and other plans which cause refinancing should be avoided.

Banks should not extend credit on a basis which permits borrowers to assume obligations which will become a hardship.

All banks should determine the expense in the handling of instalment credit and establish charges accordingly.

Customers prepaying their obligations should be allowed a refund of the unearned interest or finance charges.

Collection or late charges should be reasonable and assessed only to cover the additional expense caused by the delinquency.

SUGGESTED READINGS

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———. *Bank Manual of Installment Loans.*

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Camden, N J The Haddon Craftsmen, Inc, 1940

YOUNG, RALPH A, and Associates *Personal Finance Companies and The
Credit Practices* Camden, N J The Haddon Craftsmen, Inc, 1940

A great deal of interesting and informative reading material will be found i
the annual publications of the Proceedings of the National Instalment Cred
Conferences Theses from the library of the Stonier Graduate School of Bank
ing, American Bankers Association, are an excellent source of material, as a
those from the library of the School of Consumer Banking Members of tl
American Bankers Association can secure a catalogue of theses by writing t
the Library of the American Bankers Association, 12 East 36 Street, Ne
York 16, New York For information on the availability of theses from tl
School of Consumer Banking, Inc, the address is 840 Washington Buildin
Washington 5, D C.

chapter XVIII

TERM LOANS

THE TERM LOAN IS A RELATIVELY RECENT CREDIT DEVELOPMENT IN this country, having been used for the first time about twenty-five years ago. A term loan has been defined as "a loan to a business enterprise that is repayable, according to agreement between borrower and lender, after the lapse of more than one year."[1] A term loan generally has the following characteristics: (1) the credit is advanced for a year or longer, up to a maximum ordinarily of about ten years in the case of banks and of twenty-five years in the case of insurance companies; (2) a plan of serial repayments out of future earnings is usually provided for in a written loan agreement entered into between the borrower and the lender at the time the loan is negotiated; and (3) the loan is usually made directly with a commercial bank, an insurance company, or some other institutional lender (including pension funds) rather than sold publicly by investment bankers. The loan agreement customarily provides that the borrower will conduct his financial activities within a prescribed pattern agreed upon by the borrower and the lender.

Term loans grew from negligible amounts in 1934 to an amount equal to one half of all corporate securities held by commercial banks in 1940.[2] Through this new type of credit, the needs of businesses were adequately met, the benefits to the community were great, and the lenders developed for themselves a sound area of profitable lending. The risks involved have been demonstrated to be reasonable, and loss experience over the years has been extremely satisfactory. The further growth in dollar amount of

[1] Neil H. Jacoby and Raymond J. Saulnier, *Term Lending to Business* (New York: National Bureau of Economic Research, 1942), p. 1.

[2] *Ibid.*, pp. 25–6.

term loans and number of loans (by maturities) made by member banks is shown in Figure 111 taken from the most recent study published by the Federal Reserve Board.

Figure 111 Maturities of Term Loans Outstanding at Member Banks, Survey Dates*

Original Maturity (in years)	Amount: Millions of Dollars 1946	1955	1957	Percentage Increase 1946-55	1955-57	Percentage Distribution 1946	1955	1957
All term maturities	4 558	10 457	15 421	129	47	100.0	100.0	100.0
Intermediate term total	1 834	4 883	7 717	166	58	40.2	46.7	50.0
1-2	647	1 422	2 402	120	69	14.2	13.6	15.6
2-3	315	995	1 861	216	87	6.9	9.5	12.1
3-4	217	728	1 176	235	62	4.8	7.0	7.6
4-5	654	1 738	2 278	166	31	14.3	16.6	14.8
Long term total	2 725	5 574	7 704	105	38	59.8	53.3	50.0
5-10	2 312	4 698	6 155	103	31	50.7	44.9	39.9
Over 10	413	876	1 549	112	77	9.1	8.4	10.0

	Number: Thousands 1946	1955	1957	Percentage Increase 1946-55	1955-57	Percentage Distribution 1946	1955	1957
All term maturities	144	365	479	153	31	100.0	100.0	100.0
Intermediate term total	109	268	352	145	31	75.7	73.5	73.6
1-2	58	136	168	136	23	40.0	37.3	35.0
2-3	23	78	108	234	39	16.1	21.3	22.6
3-4	11	23	31	116	34	7.5	6.4	6.6
4-5	17	31	45	77	46	12.0	8.5	9.4
Long term total	35	97	127	175	31	24.3	26.5	26.4
5-10	29	83	101	182	22	20.4	22.8	21.1
Over 10	6	14	26	142	90	3.9	3.7	5.3

Note: Details may not add to totals because of rounding.

* Carl T. Arlt, "Member Bank Term Lending to Business 1955-57," *Federal Reserve Bulletin* (April 1959), p. 357.

TYPES OF TERM LOAN

One of the important advantages of term loans is flexibility to adapt to the special requirements of borrowers. Initially, term loans were in most cases obligations payable serially over the life of the loan. As the needs of borrowers changed, new types of term credit evolved, such as revolv-

ing credits and call, or stand-by, credits, some of which contained an additional feature permitting the borrower to convert the commitment into a term loan under certain conditions.

Serial Term Loan

Under this type of term credit, funds are made available to the borrower immediately, and the obligation is made payable serially over the life of the loan on a monthly, quarterly, semi-annual, or annual basis. The serial term loan has been used where prompt availability of the proceeds is necessary, such as for financing the purchase of a plant, machinery, and equipment; refunding existing long-term debt; funding existing current debt; or increasing working capital to handle a greater volume of business. It also has been used by a company for repurchasing outstanding shares of its own capital stock or for acquiring another company.

Revolving Credit

This bank credit permits the borrower to avail itself of funds from time to time up to the maximum amount of the commitment, with the right to repay and reborrow during the life of the credit. It is actually a line of credit for a period extending beyond one year for which the borrower is willing to pay a commitment fee based on the daily average unused portion of the credit. Generally the borrower has the right to terminate the credit at any time by giving the prescribed notice in writing or to reduce the credit whenever it is determined that the full amount is no longer necessary. Revolving credits are, as a rule, used to provide seasonal working capital needs, but they may also be used for interim construction financing when there is a pronounced seasonal factor in the flow of cash from operations and flexibility is desired.

Call or Stand-by Credit

Under this arrangement the borrower is granted a commitment by a bank for a period which permits it to borrow from time to time up to the maximum amount available to the expiration date. This differs from the revolving credit in that there exists no privilege to repay outstanding notes and reborrow such sums. Notes usually mature at the expiration of the call period, and a commitment fee is charged for the unused portion on the basis of unused daily balances. The borrower generally has the

right to reduce the credit upon furnishing proper notice This type of loan is commonly used for interim financing for construction purposes The borrower either sells equity shares or long term bonds to institutional investors for permanent financing when construction is completed In some instances it may be desirable for a bank to have a "take out" letter (i e , a commitment for long term financing) from an institutional investor as an inducement to provide the interim stand by credit

Revolving or Call Credit Convertible into a Serial Term Loan

Often a revolving, or call, credit grants the borrower an option to convert any outstanding notes and any unused portion of the credit, on or before the expiration of the revolving, or call, period, into a serial term loan repayable over a period of years This gives the borrower an opportunity to use such funds as may be needed during the interim period, terminate or reduce the credit in accordance with its needs, and convert into a term loan only the amount required Such credits may be used for working capital purposes over a longer period of time or for construction purposes If money conditions are not favorable during the call period, the borrower has the flexibility to convert into a term loan In the case of a construction stand by serial term loan, earnings generated by the new facilities can be expected to service in part, at least, the term obligation

Multiple Bank Term Loan

A number of banks may be asked to participate in a term loan if the amount of the credit is large and exceeds the legal limit of one or more of the borrower's banks of account This is often true with large national companies Also, a borrower of moderate size may have accounts with several banks and may want to have some or all of them participate in a term loan The principal bank usually negotiates the terms and conditions of the loan agreement with the borrower and then offers to the other participants the amounts suggested by the borrower, subject to the approval of a satisfactory loan agreement and required documentation The principal bank may be designated as agent for all participants in connection with transactions under the agreement, such as borrowings, repayments, and interest payments, consummated at the agent bank Sometimes there is no agent bank, and the borrower deals directly with each participant on all matters pertaining to the credit

Combination Bank-Insurance Company Term Loan

For many years banks have been working with insurance companies jointly on term financing when the loan period required is longer than that permitted by the lending policy of a bank. These loans are substantially confined to serial term loans and stand-by serial term loans. The bank or banks may take the first five to seven annual maturities, and the insurance company, the later maturities up to perhaps fifteen or twenty years. Insurance companies are generally pleased to have a bank take the earlier maturities because of its close contact with the borrower and familiarity with the borrower's business. This gives the credit a chance to season under the close observation of the bank, which continues after the bank portion is repaid, particularly when a borrowing relationship for short-term needs is maintained. In some instances both the insurance company and the bank execute the same loan agreement. Generally, however, each insurance company has a separate agreement covering its loan with financial covenants essentially the same as those in the agreements of other participants in the aggregate credit.

IMPORTANT POLICY CONSIDERATIONS

Term lending by banks differs from short-term commercial lending in numerous respects. The period the loan is outstanding may be as much as seven years or even longer, and repayment is expected to come out of earnings generated by the business rather than from liquidation of assets. The bank loan officer handling such credit should be trained in the investment approach so that he can effectively appraise the industry and the business of the term loan applicant and propose a credit arrangement on a basis that will meet the needs of the borrower and provide adequate protection for the lender. Although he should have a working knowledge of the legal aspects involved, it is advisable to have legal counsel review, if not prepare, each loan agreement and approve all required documents.

Amount of Term Loans

Management must decide how much of its funds should be allocated to term loans, the maximum period for which it will make such loans, and the industries to which it will make them available. There is a marked variation in policy among banks, which indicates that there is no set formula and, further, that there may and, indeed, should be changes in

such allocation from time to time as economic conditions change Important factors to be considered include (1) the ratio of risk assets to capital funds, (2) the ratio of deposits to capital funds, (3) the nature and type of deposits, and (4) amount of interior reserves Also, a bank with a heavy investment in real estate mortgage loans and consumer credit loans would necessarily have to limit its activity in term loans to maintain a proper degree of liquidity Other factors being equal, a bank with substantial savings deposits could justify a larger term loan portfolio than a bank with a small amount of such deposits Wide seasonal variations in total deposits or highly volatile deposits would have an important bearing on management's decision, since it is essential that a bank at all times be in a position to meet the demands of its depositors In this connection it is important to bear in mind that member banks may pledge term loan paper as collateral to borrowings from Federal Reserve Banks at a rate one half of 1 per cent over the discount rate The amount of capital funds would necessarily be a further important consideration in support of any lending policy to cover the inherent risks The results of a recent survey of a representative group of banks show the lack of uniformity among banks in the amount of term loans as related to total loans and to capital funds[3]

Percentage of Term Loans to Total Loans	Number of Banks	Percentage of Term Loans to Capital Funds	Number of Banks
25% and over	6	100% and over	9
20% to 25%	4	75% to 100%	10
15% to 20%	5	50% to 75%	8
10% to 15%	13	25% to 50%	4
Under 10%	12	Under 25%	6
	40		37

The percentage of term loans to total loans ranged from 2 to 40 per cent, and banks in the higher groups or those more heavily engaged in term lending considered either the nature of deposits or capital funds, or both, in setting term loan limits The percentage of term loans to capital funds ranged from 8 to 201 per cent In only a few instances did banks indicate a specific policy or formula in limiting term loans in relation to capital funds

Liquidity of Term Loan Portfolio

The maximum period for which term loans are granted varies greatly among banks, ranging from five to fifteen years for serial term loans and

[3] Rudolph E Palluck, "*Bank Term Loan Policies and Practices*," Graduate School of Banking, Rutgers—The State University, New Brunswick, N J., 1959

from one to five years for revolving credits. Figure 111 on page 466 indicates the term of loans outstanding at member banks in 1946, 1955, and 1957. Many banks deviate from stated policy as to maximum term when the requirements of a customer warrant it. Information regarding the liquidity of term loan portfolios is, of course, difficult to obtain. The bank with which the authors are associated has been and continues to be very active in term lending. While a maximum term of ten years is established policy, an effort is made to hold loans within a five- to seven-year pattern. At the 1960 year end approximately 62.3 per cent of term loans outstanding and unused commitments matured within three years, approximately 86.5 per cent within five years and approximately 98.2 per cent within seven years. These figures were adjusted to reflect maximum possible terms, as in the case of revolving credits or of the conversion of call or revolving credits into serial term loans where such options were available. The average weighted life of the term loans and unused commitments as so adjusted was about 3.4 years, and in the prior nine years had varied between 3.1 years and 3.8 years. Under an administrative procedure such as this, loans and commitments run off fairly rapidly, permitting a bank to revolve the portfolio if this is considered desirable. Or, if it is determined that term loans should be contracted, this can be done rather quickly and new loans can be limited to select credits of a high quality.

Diversification of Term Loan Portfolio

Conservative term lending practice requires that a bank diversify loans so as not to concentrate unduly in any one industry or type of business and so as to give some consideration to spreading term risks geographically. The authors know of no bank that has a formal diversification pattern or formula. In practice many banks review their industry allocation periodically and make such changes as may be deemed necessary in the light of existing economic conditions and anticipated trends. There are certain exceptions to diversification. For example, some banks in the Southwest make a relatively large amount of term loans to oil production companies. This may be justified because of the intimate knowledge the banker has of the businesses, the managements, the fields being drilled, and the petroleum engineers who furnish reports on the properties operated. Although diversification is desirable, each bank must decide the extent to and direction in which it will commit itself for term loan investments.

The types of business financing their requirements through bank term loans vary greatly as shown in Figure 112 of the 1957 Federal Reserve Board survey Manufacturing and mining ranked first in total dollar volume of term loans, public utilities, second, retail trade, third, real

Figure 112 Business of Term Loan Borrowers Related to Size of Lending Member Bank (*October 16, 1957*)*

Business of Borrower	All Banks	Size of bank (total deposits in millions of dollars) Less than 10	10 – 100	100 – 500	500 – 1,000	1 000 and over
	Amount of loans (in millions of dollars)					
All Businesses	15 421	585	2 069	2 688	1 726	8 354
Manufacturing and Mining						
Food liquor and tobacco	485	14	68	79	53	272
Textiles apparel and leather	314	6	30	59	34	184
Metals and metal products	1 905	17	147	334	227	1 179
Petroleum coal chemicals and rubber	2 763	18	88	252	253	2 152
All other	1 067	33	126	178	148	583
Trade						
Retail trade	1 387	188	406	323	134	336
Wholesale trade	600	31	144	182	39	203
Commodity dealers	88	6	11	14	29	29
Other						
Sales finance	266	3	12	30	53	168
Transportation communications and other public utilities	2 839	31	130	323	335	2 020
Construction	596	36	144	158	78	181
Real estate	1 307	36	300	368	146	458
Service	1 194	140	351	245	115	344
All other non financial	611	27	113	143	82	246
	Percentage increase or decrease ( ) 1955 - 57					
All Businesses	47 5	43 2	43 7	36 8	43 3	53 6
Manufacturing and Mining						
Food liquor and tobacco	15 6	24 3	56 1	7 3	26 0	23 4
Textiles apparel and leather	19 6	81 7	55 7	8 7	9 9	25 1
Metals and metal products	59 6	18 8	38 0	64 6	50 3	64 2
Petroleum coal chemicals and rubber	44 4	73 4	13 0	7 2	33 2	53 8
All other	45 5	62 5	54 7	24 0	44 1	51 0
Trade						
Retail trade	29 1	48 2	47 2	36 6	33 7	0 2
Wholesale trade	41 2	47 2	62 6	60 9	12 1	29 3
Commodity dealers	58 6	24.7	6 2	266 6	399 2	-9 0
Other						
Sales finance	103 2	18 7	41 7	139 2	30 0	151 3
Transportation communications and other public utilities	46 1	85 1	33 6	4 1	41 3	57 5
Construction	76 1	40 6	54 8	93 4	190 6	78 4
Real estate	77 6	41 3	48 6	62 0	48 9	148 8
Service	47 9	37 0	42 9	51 8	116 0	40 1
All other non financial	44 0	11 2	24.3	30 4	137 1	49 2

Note Details may not add to totals because of rounding

* Carl T Arlt, "Member Bank Term Lending to Business, 1955-57," *Federal Reserve Bulletin* (April 1959), p 368

estate, fourth; and service, fifth. Petroleum, coal, chemicals, and rubber represented the largest group within the manufacturing and mining total, with metal and metal products ranking second. It is also interesting to note the participation in term loans by banks of various sizes classified by amount of deposits.

Factors Affecting the Credit Risk

The factors involved in the extension of short-term bank credit were considered in earlier chapters of this book. While these are pertinent and require the banker's attention when contemplating the extension of credit for a longer period of time, additional factors, which may have little significance if the loan is to run for only ninety days, need to be carefully weighed in granting longer-term credit. Competent management and a satisfactory earnings record are essential qualifications for a term loan. For example, when a banker extends short-term credit to a cannery to pack a corn crop, he will be interested in whether the borrower will be able profitably to market his product within a number of months and thus retire his obligation out of the proceeds of the sale of the canned goods. If, however, the borrower obtains longer-term credit to expand his plant and equipment, with the loan running for a period of five years, and with monthly payments on the principal, the banker will be vitally interested in the income of the enterprise for the next five years. Regular income at a level sufficient to meet the principal maturities and interest payments thus becomes imperative and a cardinal requirement when a term loan is being considered.

Bankers are not clairvoyant and therefore cannot ascertain with certainty the future earnings of any enterprise. However, there is information that will aid them in evaluating the borrowing concern and thus assist them in arriving at a reasonably sound conclusion about the great majority of requests for term loans. A consideration of these aids or techniques is important. First, the banker should examine the past earning record of the prospective borrowing concern. He should not only note the trend but also make comparisons with similar concerns to see whether the applicant's relative growth and margins are satisfactory and its relative capital structure in line. He should compare, particularly, the relative earning patterns during periods of prosperity as well as during periods of depression. He should also have prepared for analysis application of funds statements for prior years which show the cash-generating ability of the business from earnings and non-cash charges, dividend policy, ex-

penditures for fixed assets, and other factors that affect working capital

The earnings should be adjusted to allow for all possible contingencies, because the period involved is relatively long The earnings should be averaged, as it were, with ample allowance for periods of economic prosperity and depression and for unexpected difficulties Then the banker should determine whether the earnings appear to be sufficient to meet the requirements of the proposed term loan

In a sound analysis of a company's earnings it is essential to have certain operating information, of which the following items are most significant gross sales, net sales, gross profit, operating expenses, operating profit, pretax profit, and net profit or loss The trend of these items and the trend of operating margins should be noted, and the effect on earnings of changes in either direction should be carefully considered Significant and worthy of investigation is the general topic of the source of income of the enterprise being considered, for occasionally income from activities outside the operation of the business is a major part of the total earnings Such sources of income may be less regular and less certain than the income from the regular operations of the business Moreover, outside operations may take a disproportionate part of the time of management in relation to the income received The past and current earnings of an enterprise furnish a primary test as to whether or not the enterprise is credit-worthy of a term loan, and, in addition, they serve as an index of the ability of management Also, they will permit the lender to evaluate projections, which the applicant should be required to furnish, consisting of operating statements, schedule of cash receipts and cash disbursements, and balance sheets, all of which should give effect to the proposed term financing program The time covered by the projections may vary according to the nature of the business and the reliability of estimates required The first year should be on a monthly basis, this will indicate how the term loan will be worked into operations, the seasonal impact, if any, on cash, sales, receivables, and inventories, the need for short-term loans, and whether such current loans can be cleaned up for a reasonable time during the year Failure to liquidate current loans may mean that additional term money or a longer repayment is needed, or both Projections for subsequent years may be presented on an annual basis

In attempting to plot the trend of future earnings, there are additional significant factors that must be considered Probably most important is that of the economic position of the industry itself, and the products marketed and services furnished The relative elasticity of the demand

for the product and the probable effect of economic depression and prosperity should be investigated. Are the products of the industry essential? Are the markets greatly limited? Competitive conditions within the industry should also be noted, as well as possibilities for expanding its horizon of activities and services. The attitude of the Government toward the industry as well as labor conditions are factors not to be ignored.

The management itself is one of the most important single factors. If the management has demonstrated ability and sound judgment in the past, what is there to insure its continued operation? Determined and positive steps should be taken to maintain sound management policies. This can be done by having young men, trained by men of proven executive ability, working toward positions of management control. Competent, experienced management is the dynamic determining factor in the success or failure of a business enterprise.

After he examines the industry as a whole, the banker must also consider the company's employer-employee relationships, copyrights, trademarks, costs, and distribution methods, which may all in one way or another affect the future earnings of the company.

In summary, a banker considering a request for a term loan should explore every factor that has any bearing on the ability of the prospective borrower to discharge his obligations as they mature. These will include, as suggested above, a study of the industry, the relative competence and efficiency of the management, and, finally, the history, methods, and operations of the would-be borrower.

SECURED AND UNSECURED TERM LOANS

In most cases the soundness of a term loan may be measured by the adequacy of future earnings to retire the loan. Nevertheless, the pledging of assets whose appraised value is adequate to secure a loan properly is desirable in some instances. The study by the Federal Reserve Board indicates the amount of secured and unsecured term loans of member banks of the Federal Reserve System as of October 5, 1955, as well as the size of the borrower (see Figure 113).

As of October 5, 1955, 40.8 per cent of the term loans extended by member banks were secured, and 59.2 per cent were unsecured. The largest volume of secured term credit was on plant and other real estate, and the next largest amount on equipment. It should be noted that the percentage of unsecured loans increases markedly as the size of the bor-

rower increases While only 6.2 per cent of the term loans was made to borrowers with total assets less than $50,000, 77.5 per cent was made to borrowers with total assets of $100,000 and over

Figure 113 Type of Security Pledged for Member Bank Term Loans, October 5, 1955, within Size-of-Borrower Groups*

Type of Security	All borrowers†	Size of borrower (total assets in thousands of dollars): Less than 50	50–250	250–1 000	1 000–5 000	5 000–25 000	25 000–100 000	100 000 and over
	Amount (in millions of dollars)							
All Term Loans	10 457	581	1 348	1 212	1 314	1 679	1 563	2 358
Unsecured	4 266	36	72	122	341	827	1 018	1 826
Secured total	6 191	544	1 276	1 909	973	852	545	532
Endorsed or co maker	489	51	60	74	84	73	61	52
Assignment of Claims	1 055	19	55	103	226	295	184	98
Other Security	329	8	20	43	53	109	22	28
Inventories	85	4	17	12	22	9	6	3
Equipment	1 548	156	215	252	250	204	118	271
Plant and Other Real Estate	2 337	298	884	582	289	93	43	26
U S Government Securities	20	‡	2	2	1	4	2	8
Other Bonds	39	‡	‡	1	1	5	14	18
Stocks	237	3	12	11	33	56	95	22
Life Insurance and Savings Accounts	52	5	11	12	14	3		5
	Percentage distribution of all term loans							
Unsecured	40.8	6.2	5.3	10.0	26.0	49.3	65.1	77.5
Secured	59.2	93.8	94.7	90.0	74.0	50.7	34.9	22.5
	Percentage distribution of all secured term loans							
Endorsed or co maker	7.9	9.3	4.7	6.8	8.6	8.6	11.2	9.8
Assignment of Claims	17.0	3.6	4.3	9.4	23.2	34.6	33.8	18.5
Other Security	5.3	1.4	1.5	4.0	5.4	12.8	4.0	5.3
Inventories	1.4	0.8	1.3	1.1	2.2	1.1	1.1	0.6
Equipment	25.0	28.6	16.8	23.1	25.7	24.0	21.7	50.9
Plant and Other Real Estate	37.7	54.7	69.3	53.4	29.7	10.9	7.9	4.9
U S Government Securities	0.3	0.1	0.1	0.2	0.2	0.5	0.4	1.4
Other Bonds	0.6	‡	‡	‡	0.1	0.6	2.5	3.3
Stocks	3.8	0.5	0.9	1.0	3.4	6.6	17.4	4.2
Life Insurance and Savings Accounts	0.8	1.0	0.9	1.1	1.4	0.3		1.0

Note Details may not add to totals because of rounding

* Carl T Arlt, "Member Bank Term Lending to Business, 1955–57," *Federal Reserve Bulletin* (April 1959), p 361

Various types of asset have been pledged as security for term loans, some of which are included in the following list

Land and building
Machinery and equipment
Stocks and bonds

Inventory
Assignment of cash surrender value of life insurance policies
Railroad trains and equipment
Assignment of rents and contracts
Warehouse receipts
Accounts receivable
Production of oil
Cargo ships
Assignment of claims

THE TERM LOAN AGREEMENT

One of the characteristics of a term loan is that a written agreement between the borrower and the lender is usually signed at the time the loan is consummated. The agreement is one of the conditions of the loan and is prepared to fit the requirements of the particular term loan being considered. Legal counsel should be familiar with this type of lending, so that the language in the agreement will accurately state the mutual understanding reached between the parties, particularly in regard to the financial covenants. While some banks have house counsel who handle the legal details, most have outside special counsel, whose fees are generally paid by the borrower.

The term loan agreement consists of four principal sections: (1) description of the credit, (2) representations and warranties, (3) financial covenants, and (4) default provisions.

Description of the Credit

This section should set forth the amount of the credit, the participants if any, their proportionate shares, and the time of take-down or term of the credit if it is a call or a revolving credit. It should state the maturity of the notes, rate of interest, commitment fee if any, collateral security if any, voluntary prepayment provisions, and reduction or termination privileges.

There does not seem to be complete uniformity among banks regarding the type of interest rate in term lending. Fluctuating rates (i.e., the prime rate or a fraction over prime in effect from time to time) are commonly used in revolving credits, with maximum and minimum limits in some cases and no such limits in others. Many banks still prefer a fixed rate on serial term loans, since it permits the borrower to know exactly what the interest cost is going to be over the life of the loan, to having it depend

on the prime rate in effect from time to time However, there has been a trend in the past few years toward fluctuating rates on serial term loans

Representations and Warranties

In considering the application for the loan, the lender has relied on certain information furnished by the borrower The borrower, therefore should be required to warrant that such information is true and correct as of the date the loan ageement is executed Among the principal items included are

1 Annual audit for the latest fiscal year, certified by independent accountants

2 Latest interim financial statements certified by a responsible officer of the company

3 The borrower is duly organized and is authorized to execute the agreement and the notes

4 Outstanding liens on assets

5 Funded debt outstanding

6 Investment in subsidiaries and other entities

7 Guarantees of obligations of others

8 Pending litigation

9 Latest year for which Federal income tax returns have been audited and cleared by the Internal Revenue Service

Financial Covenants

The lender seeks to protect his loan by requiring the borrower to comply with certain financial covenants Whether these are few and basic or many and detailed will depend on the quality of the credit There is no standard set of covenants to apply to all situations Businesses differ in many respects, as do industries, and for that reason it is necessary that covenants be specifically tailored in each case They should be no more restrictive than the policies that any conservative management would follow to maintain a good credit rating, and should be designed to prevent any material deterioration in the financial condition of the borrower or credit preferences If this happens, an event of default (see page 479) should occur, and the lender should be in a position to accelerate the maturity of the loan if he so desires Should the borrower at any time wish a consent or waiver of a restriction or a modification of a covenant for a sound reason, this can be accomplished readily by negotiation with

the lender provided it is considered in the best interests of both parties. Among the more important covenants commonly used are the following:

1. Purpose for which proceeds of the loan are to be used.
2. Proper maintenance of property owned by the company.
3. Furnishing of financial statements annually, quarterly, and occasionally monthly.
4. Maintenance of minimum working capital and, in some cases, minimum current ratio.
5. Restriction on pledge of assets.
6. Restriction on creation of other indebtedness.
7. Restriction on payment of cash dividends and repurchase of shares of own capital stock.
8. Restriction on investment in, loans and advances to, and guarantees of debts of others.
9. Restriction against merger with or consolidation into any other entity.
10. Restriction against sale of principal assets other than in the ordinary course of business.
11. Restriction on amount that may be expended for acquisition of fixed assets.
12. Restriction against sale and lease-back deals and lease rentals.
13. Restriction against sale of notes or accounts receivable.
14. Restriction against voluntary prepayment of other outstanding term debt.

Default Provisions

Upon breach of certain provisions in the agreement, the borrower may be granted a period of time after notice by the lender to remedy the breach, and if this is not done, an event of default occurs. In some situations an event of default may be automatic, requiring no action by the lender to accelerate maturity, while in other instances it may be automatic but require the lender to notify the borrower that he has declared the obligation due and payable. Following are common default provisions:

1. Any representation or warranty by the borrower in connection with the agreement be materially false.
2. Non-payment of principal when due.
3. Non-payment of interest within a specified time after it becomes due (up to ten days).
4. Breach of any negative covenants.

5 Default upon or failure to pay any other obligation when due

6 Bankruptcy of the borrower

7 Failure of the borrower to deny and have vacated within a specified time any bankruptcy or reorganization proceedings instituted against it (frequently thirty days)

8 Appointment of a trustee or receiver for a substantial part of the borrower s property in any involuntary proceeding and not vacated within a specific time (frequently thirty days)

9 Consent by the borrower to appointment of a trustee or receiver for a substantial part of its property

10 Assignment by the borrower for the benefit of creditors or admission by him in writing of inability to pay debts as they become due

11 Failure of the borrower to discharge any judgment against it within a specified time (frequently thirty days)

12 Breach of any other provision of the agreement which is not remedied within a specified period after written notice from the lender (frequently fifteen to thirty days)

Required Documentation

The loan agreement should set forth the fixing of the borrowing date or dates and the documents to be furnished by the borrower These generally include the corporate charter, bylaws corporate resolutions, and opinion of counsel If Government or stockholder approval is required, evidence of it should also be furnished

SERVICING THE TERM LOAN

The granting of the term loan marks the beginning of a close relationship between the borrower and the lender It is only in this manner that the lender can effectively follow the activities of the company, and keep abreast of current operations and indicated trends, and be in a position to offer assistance when circumstances require Also, it is important that the borrower comply with all terms and provisions of the loan agreement. This requires constant scrutiny by the lender

The occurrence of an event of default permits the lender to accelerate the maturity of the loan and to demand the immediate payment of principal and accrued interest It is therefore essential that the breach of any covenant be determined promptly and that the responsibility for this function be assigned to competent personnel This varies among banks,

but generally the credit department has the responsibility. In some banks the loaning officer or an assistant handles it. The financial statements will, in most cases, provide a substantial part of the information required to determine whether the borrower has complied with covenants. Frequently the agreement requires that the company's independent accountants furnish an annual certificate stating whether any violations were observed in the conduct of the audit. The principal financial officer of the company may also be required to furnish a similar certificate.

As conditions change in an industry, the needs of individual businesses also change in order that progress and growth may continue. It is not often that a term loan is retired in full as scheduled without some amendment having been made to the original covenants or some consent or waiver granted to permit the borrower to consummate a transaction prohibited without the approval of the lender. Whatever the transaction might be, the borrower may at any time discuss it with the lender, and if it appears reasonable, sound, and beneficial to both borrower and lender, prompt approval can be expected. This facility in term loan administration is possible because of the banker's intimate knowledge of the company's activities and is one of the important features that makes bank term loans attractive to customers of the bank.

TERM LOAN TO A MANUFACTURER

Adams Manufacturing Co. made a complete line of high-quality cloth shades in a wide range of colors and sizes and a line of plastic and paper shades in the popular price range. Sales were made through fifteen branches located in large cities throughout the country. It had an old but well-maintained and well-equipped plant. The company depended on a supplier, also a competitor, for a substantial part of its shade rollers. The supplier decided to discontinue operations and sold its shade facilities to another manufacturer. Adams Manufacturing Co. purchased the roller business, which it believed imperative in order to assure its roller supply. Included in the purchase were machinery and equipment for $188,000, paid for in cash, and roller inventories, including raw materials, for $326,000, for which the company gave its notes repayable over a three-year period. The seller's roller plant was leased for a twenty-five-year period at $20,000 annually with an option to purchase the plant for $232,000. The company gave a $46,500 note, repayable at $5,812.50 semi-annually, for the option right.

The management decided to exercise its option to purchase the plant

and sought financing for this purpose and to retire notes given for the roller inventory Investment bankers were selected to negotiate with insurance companies for a $500 000 fifteen-year term loan, but a turn-down was received for this amount Subsequently they had a turn down for a $375,000 ten year term loan from a second company It was at this point that Mr Adams, the chairman and principal stockholder, came to the bank and asked for assistance The company had maintained an excellent relationship for over twenty years, using its seasonal credit facilities regularly up to $100 000, with a clean up for substantial periods each year Average balances carried by the company and by Mr Adams personally exceeded the maximum credit granted There were no accounts at other banks

Financial Data

Mr Adams had organized the company more than thirty years before, and its operating record had been good, particularly in recent years Although Mr Adams was now over seventy years of age, he had brought in Mr E F James as president five years before, and the latter had done a fine job of running the business The company had capable people in the principal management positions Net income for the past four calendar years averaged $69,000 with a dividend pay out of $10,000 annually Net income for the first quarter of the current year was $44,000 Sales had been trending up steadily, reaching $2,250,000 for the latest fiscal year It was expected that with the discontinuance of an important competitor in the industry, Adams Manufacturing Co would be able to increase its volume appreciably and would benefit materially from savings to be realized from the manufacture of its own rollers and the sale of rollers to others

While the latest balance sheet prior to the acquisition of the roller plant (see Figure 114) showed working capital of $910,000 and net worth of $1,190,000, it also had outstanding deferred notes of $232,000 repayable in three years Additional term debt was required to finance the acquisition of the plant Since the statement date, $30,000 of common stock was sold to officers Upon a review of earnings projections of the existing facilities and the benefits anticipated from the roller business, the loan officer concluded that the company could reasonably service a seven-year $375,000 term loan to be repayable in equal quarterly instalments, provided that Mr Adams made a $125,000 loan to the company for the

remaining funds needed, such loan to be subordinated to the term loan. This program was entirely agreeable to Mr. Adams. In summary, the roller business acquisition was financed as follows:

Assets Acquired		Funds to be Provided by	
Inventory	$326,000	Subordinated Notes	$125,000
Machinery and Equipment	118,000	Sales of Stock	30,000
Plant	232,000	Bank Term Loan	375,000
		Corporate Funds	146,000
	$676,000		$676,000

Figure 114 Comparative Balance Sheets (*in thousands of dollars*) for Adams Manufacturing Co.

	(Year E) End of Three Months	(Year D) End of Last Year	(Year C) End of Second Preceding Year	(Year B) End of Third Preceding Year	(Year A) End of Fourth Preceding Year	Pro Forma
Assets						
Cash	$ 174	$ 169	$ 175	$ 129	$ 83	$ 126
Accounts Receivable	245	135	150	110	128	245
Inventory	833	584	601	707	579	833
Current Assets	$1,252	$ 888	$ 926	$ 946	$ 790	$1,204
Land, Buildings, Machinery & Equipment	635	513	413	401	397	868
Less Reserve for Depreciation	173	169	154	140	138	173
Net Fixed Assets	$ 462	$ 344	$ 259	$ 261	$ 259	$ 695
Deposit on Acquisition of Roller Business		50				
Cash Value Life Insurance	10	10	9	9	9	10
Prepaid Items	15	4	5	4	3	15
Total Assets	$1,739	$1,296	$1,199	$1,220	$1,061	$1,924
Liabilities						
Notes Payable Bank	$ 50	$ 50	$ -	$ 75	$ -	$ 50
Notes Payable Others	118	-	-	-	-	-
Bank Term Loan Current	-	-	-	-	-	53
Accounts Payable	78	12	48	53	66	78
Accruals	20	36	24	32	14	21
Federal Income Taxes	85	78	70	65	42	85
Current Liabilities	$ 351	$ 176	$ 142	$ 225	$ 122	$ 287
Notes Payable Others	198	-	-	-	-	-
Bank Term Loan	-	-	-	-	-	322
Subordinated Debentures	-	-	-	-	-	125
Common Stock	919	889	889	370	370	919
Retained Earnings	271	231	168	625	569	271
Net Worth	1,190	1,120	1,057	995	939	1,190
Total Liabilities	$1,739	$1,296	$1,199	$1,220	$1,061	$1,924
Working Capital	$ 901	$ 712	$ 784	$ 721	$ 668	$ 917
Working Capital (after Senior Debt)	703	712	784	721	668	595
Net Sales	594	2,221	1,935	1,794	1,565	
Pretax Profit	87	153	139	132	106	
Net Income	44	76	69	68	65	
Cash Dividends	5	13	8	11	8	

The Loan Agreement

The loan agreement contained the usual financial covenants necessary to maintain the company's credit standing and liquidity However, in view of Mr Adams' age, the dividend covenant was designed to permit the company to pay cash dividends out of only 40 per cent of earnings after year E, subject to a minimum working capital figure 20 per cent higher than that for default purposes, provided also that the company could, at its discretion, use such funds otherwise available for dividends to make prepayments on the subordinated debentures

This program has worked very well, and all terms and conditions are being complied with properly

SUGGESTED READINGS

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chapter XIX

FARM LOANS

THE PRINCIPLES UNDERLYING THE EXTENSION OF AGRICULTURAL credit are similar to those in the extension of other credit. The differences in administration are due primarily to the following unique factors:

1. Agriculture is primarily an individual and a family enterprise. Living expenses are comparable to salaries paid or other forms of withdrawal, and in this respect are a form of operating expense.

2. The fact that so many living needs can be produced on the farm makes possible the existence of more marginal operators and the continued operation of many even under adverse conditions.

3. With increased application of mechanized farm methods and techniques, of commercial fertilizers, and of improved seed, the ratio of costs to gross income is increasing. It now takes $.70 in operating expenses to produce $1.00 of income; ten years ago it took $.50, and scarcely a generation ago farmers were able to retain $.70 of each $1.00 of gross income. Today success in farming is less a matter of hard work and more a matter of business and management ability. Since every farm operator is an individual businessman, the resultant problems are primarily of an individual nature.

4. The amount of capital required, including the value of the land farmed, is high in relation to annual sales and income.

5. Limited control of production is exercised by varying the kinds of crop or the quantity planted. Fundamental shifts in agricultural production come *after* the operation of the laws of supply and demand rather than in anticipation of them. Farmers act independently, are encouraged to increase production when prices are high, and are forced to do so when prices are low. Agricultural output is largely dependent on climatic conditions beyond human control.

6 The lack of planned and unified marketing control, coupled with the fact that most agricultural products are of a perishable nature, causes violent price fluctuations in short periods of time. A nominal shortage or an excess of production in relation to demand causes price fluctuations materially disproportionate to such divergencies. Marketing follows seasonal production. Price fluctuation often reflects the relation of supply to current rather than anticipated demand. The varying flow of products to processors and distribution agencies creates problems that contribute to this price instability. Few farmers have the required capital and facilities for withholding non perishable products from market during periods of low prices.

7 The nature of demand for agricultural products is dependent on the level of consumer purchasing power. As buying power increases, the demand for such farm processed products as meats and poultry tends to increase. As buying power decreases, the less expensive and more plentiful cereal foods are purchased by the consumers. From four to twelve pounds of grain are required to produce a pound of processed farm foods, while only one fourth to one third as much grain is required to produce foods in cereal form. Therefore, such a shift in eating habits, following a reduction in consumer purchasing power, accentuates the problem of oversupply.

8 Breeding stock and dairy cattle are fixed assets when and to the extent that they are used to produce agricultural products. The same assets, however, will eventually be sold for human consumption, and the proceeds therefrom have debt paying value. Such assets are thus properly classed as current assets.

9 For economic, social and political reasons attempts are made to control production, to carry or dispose of surplus, and to finance agriculture through government channels. In the confusion of economic, social, and political objectives, surpluses have increased, farm programs have become costly, and too often, marginal operations and inefficiencies have been subsidized.

10 Notwithstanding wide price fluctuation, there is always a market for agricultural products. Used fixed assets are sold at public auction sales, bringing current prices.

11 Farm population is decreasing, and the size of the farming unit is increasing. At the same time there is an increase in the number of part-time farmers, of families who have off the farm income from teaching, clerking, or working in mills and woods or from other sources. There is a trend from diversification to specialization. The farmer with twelve

cows, six sows, and forty acres of corn is a figure in history. Today efficiency is measured in the number of pounds of milk, bushels of grain, and pounds of meat an individual produces. Such efficiency requires improved methods and knowledge and substantial and increasing capital investments.

12. In the poultry industry the production and marketing of eggs, broilers, and turkeys under contract and supervision is well established in certain areas. The corporate method of raising and marketing produce is found in some of our southern states. There are examples also of corporations that are outgrowths of successful family enterprises. The custom feeding and marketing of cattle for others; the milk pools or custom care and milking of cows for others; the "pig parlor" method of raising hogs—these have met with varying degrees of success. With labor and other costs more rigid, such operations lack the flexibility and adjustability of the individual family enterprise and are thus more dependent for success on capital and management. The discussion here is directed to the individual or family operation.

A recognition and understanding of the foregoing factors will help the lender to accommodate borrowers profitably.

THE FARMER'S CREDIT FILE

The prime function of credit administration in the country bank, essential for the mutual protection of the customer, the bank, and the community, is the maintenance and intelligent interpretation of adequate credit data and operating information.

The credit file is the most important tool the banker uses in the administration of credit. In each case the banker must decide the amount of credit information required and the forms to be used. The extent to which a bank can determine the amount of credit that can be safely and wisely extended is measured by the quality of the credit information maintained and by the use that is made of it. Customers have just cause for complaining of "red tape" if the information required serves no purpose. Credit files that are unwieldy, confusing, or not used are costly and of little value.

Financial Statement

The most important credit instrument is the financial statement. Assets should be listed in detail, indicating their quality and sufficiency. They should be grouped as to debt-paying use. Fixed liabilities are payable

from future earnings, current liabilities are payable from current income and from assets on hand that are to be sold The most acceptable statement form will be one that is clear and easily interpreted

In addition, the statement should show the title and ownership, classification of land, improvements, the scope and nature of the farming operations, insurance carried, operational income and expenses, indirect liabilities if any, and such other information about the family as will give the lender a complete picture The purpose of the loan and plan of repayment may be incorporated in the financial statement or made a part of the loan application

A form of financial statement shown in Figure 115 is fully detailed, yet sufficiently simple so that it can be prepared within a reasonable time With space provided for five years, a comparison of statements is convenient and automatic Machinery need be listed in detail only once, and thereafter deduction for depreciation is automatic and accurate Many people would feel that all feed is current assets, but only feed that can be used for debt repayment should be so classified

Space is provided on the reverse side of this form for projection of annually anticipated income and expenditures Making up the projection form does take time, and for that reason it is used primarily in the case of new farm loans, of operators with limited capital, and where a comparison of financial statements indicates a lack of desired progress

Also on the reverse side of the financial statement is space for anticipated financing needs, setting forth repayment plans, a form of guarantee to be signed by the spouse, especially needed where title is held jointly with rights of survivorship, and the five lines for maker signature and dating

Some country bankers use a form of financial statement that they mail to their customers each year at about the same time, the customers prepare and return it or bring it to the bank after they have ascertained the needed information There is much to be said for this method The inventory accuracy is usually more dependable, and there is a definite advantage in receiving a financial statement at the same time each year, preferably in early spring after winter expenses have been paid, when financial conditions are usually at a low point

The Projection Sheet or Budget Form

Particularly in the case of a new lending relationship or of a marginal operation, it is essential that a projection be made of anticipated income,

Figure 115A Form of Financial Statement for Obtaining Information for a Farm Loan (*front*)

ASSETS	No.	Av. Wt.	Amount	No.	Av. Wt.	Amount	No.	Av. Wt.	Amount
Cows									
Cows									
Cows									
Heifers									
Heifers									
Steers									
Steers									
Calves									
Calves									
Bulls									
Sows									
Shoats									
Pigs									
Ewes & Bucks									
Lambs									
Horses									
Crops for sale									
Chickens									
Cash in Bank									
Other—List									
TOTAL Current and Semicurrent assets									
Feed: Barley									
Oats									
Wheat									
Hay									
Silage									
Machinery									
Real Estate									
TOTAL ALL ASSETS									
LIABILITIES To Ravalli County Bank									
On									
To									
On									
To									
On									
To									
On									
To									
On									
Other—List									
Unpaid Taxes									
TOT CURRENT LIABILITIES									
Real Est Mgs									
TOTAL LIABILITIES									
NET WORTH									
CONTINGENT LIABILITIES To									
To									

as a true and accurate statement of the financial condition of the undersigned on the date ... to notify said bank promptly of any material change therein.

MACHINERY SCHEDULE

Yr. Bt.	Items	Cost	Value

REAL ESTATE SCHEDULE

Mmt Date	Acres	Items	Cost	Value
		Irrigated Crop		
		Irrigated Hay		
		Irrigated Pasture		
		Dryland Crop		
		Dryland Hay		
		Dryland Pasture		

Improvements	Ins		
	Acres TOTALS		

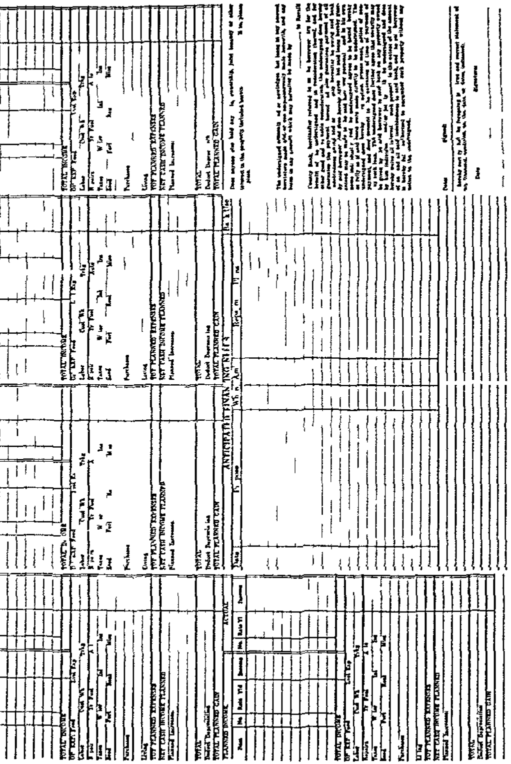
Later Additions And Deductions	Depre	Value

Real Estate Mortgages and Terms	Owed

Schedules of Other Assets	Amt

WATER RIGHTS AND AVAILABILITY

Figure 115B Form of Financial Statement (reverse)



expenditures, borrowing needs, and repayment plans. Of greater importance than the security offered is the question of how profitable the loan will be to the borrower.

The first obligation of any borrower is to provide the living necessities for his family; the next is to pay operating expenses; and only from what is left can repayment be made to the bank without having to resort to liquidation of security held. A banker in the habit of loaning on feeder cattle is apt to think of one hundred cows as choice security. A banker financing the raising of cattle knows that in a cow-calf operation a hundred-cow herd is marginal in the average instance. A loan of $100 with chattel security on one hundred cows might help pay a grocery bill and be well secured, but it is of no help to the borrower. It won't help him make money to repay the loan or get ahead.

Two general forms may be used. One form follows the form of the Federal income tax return and deals in annual income and annual expenditures. A second form breaks expenditures and income into the seasonal quarters of the year, thus providing a little more accurate picture of the timing of borrowings and of repayments. Both forms have their advantages, and in each, provision should be made for actual results with which to make comparisons.

The simple answer to the question, "How will you repay the loan?" is adequate providing that the source of income materializes in the anticipated amount and that there are no other more urgent uses of that income. Projection or budget forms aid in a more comprehensive and accurate appraisal of the value of the loan and of the ability to perform. Each banker can prepare such a form, basing it on the normal sources of income and markets and on the normal items of expenses and costs prevailing in his area.

Statement Comparisons

The financial and operating statements provided by businessmen are presumably as taken from their books and business records. Few farmers' statements, however, are a copy of records kept by them. Inventory values in business statements are customarily based on the lower of cost or market. In farmers' financial statements inventory valuations are often the borrower's opinion of current market values, which fluctuate from year to year. Even on fixed assets the market will fluctuate. In good times farmers can afford new equipment, and used equipment sells poorly. In bad times the need to economize forces the prices of used equipment

higher than is reasonable Too often valuations given to annual inventory listings are dependent on the faulty memory or the mood of the borrower Real estate values too seldom show cost but instead reflect what the borrower "would sell for"

Adjusted Net Worth Statement

Where the five-year statement form is used, variances of machinery and real estate valuations are eliminated, and variations in other valuations are more apparent Bankers can often make needed compensation or adjustment for such inventory valuation variations But there are instances where more accurate records and testing should be made These are achieved by means of an adjusted net worth statement In such a statement the various classes of livestock are given a fixed unit value, and this same unit value is used each year The following are examples of fixed unit values that might be used cows and bulls, $100, two-year-old heifers, $75, yearling heifers, $50, steers, $60 or, if purchased, at cost, calves, $25, cattle on feed, $100, sows, $40, shoats, $20, pigs, $10, ewes and bucks, $18, lambs, $10, horses and mules, $75, and colts, $25 The fixed unit values should have a reasonable relationship to each other in order properly to reflect shifts in the types of operation The objective is to show not present market value but any gain or loss in the periods between statements and show economic trend lines After all, a farmer who lists a hundred cows one year at $100 a head doesn't make $10,000 by listing them at $200 a head, or lose $5,000 the following year by showing them at $150 a head

Logically all farmers should make progress during periods of rising prices The use of adjusted net worth comparisons shows that even in periods of greater prosperity marginal operators actually lose or fail to make the progress they should The use of increased valuations gives them a misleading sense of affluence and is too often misleading to the banker as well

Better farmers will make progress under even adverse conditions If the banker can properly evaluate his customer's ability, he can extend and administer credit more wisely and with greater confidence A banker should maintain files containing such complete credit information that he can intelligently discuss the credit problems unique to each customer Thus, the banker should be in a position to point out adverse trends in time and make suggestions to correct them A majority of farmers have

the ability to correct their own shortcomings if they recognize them soon enough.

Comparison of the adjusted net worth statement of one farmer with those of others is also enlightening. In fact, the study of such statements affords a wealth of research material. A sound credit philosophy does not seek simply to answer the question, "Is the customer good for the loan?" but it aims rather to answer the question, "What benefit will the customer derive from the loan?" This form is particularly valuable in helping a banker to extend credit wisely to those who may need assistance and who will use it advantageously.

Comment Sheet

Every credit file should contain a running comment sheet on which should be recorded visits, inspections, plans, commitments, and other information about the borrower and his family which may be of value to the banker. It should also contain statements of security held and such legal papers as are received.

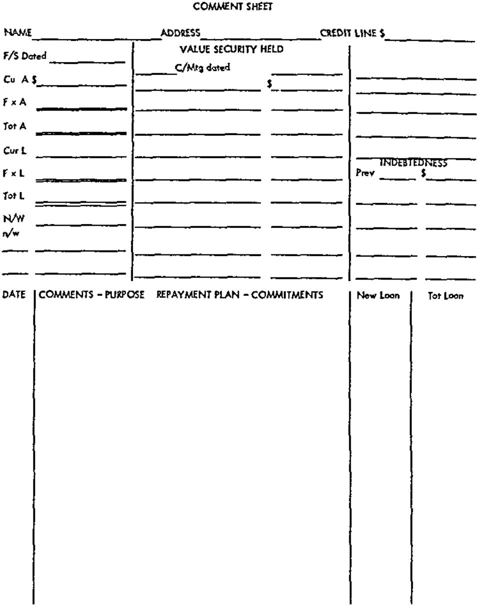
The comment sheet may be a simple blank sheet, or it may be a more complete form as shown in Figure 116. This form is simple to set up and maintain; it shows at a glance the date of the last statement, the relationship of the various types of assets and liabilities, the net worth as shown in preceding statements and in the current statement, the type and value of security held, with space for other types of security, such as a guarantee or collateral. Established credit lines, the amount of the new loan, and the amount of the total bank indebtedness are shown. This type of comment sheet is particularly useful and convenient to the board of directors or the loan committee in reviewing loans and determining credit lines.

AGRICULTURAL BANKERS

The place of agriculturally trained men in banks is well established. Agricultural representatives in banks have their own organizations, such as the Upper Midwest Agricultural Credit Council in the Ninth Federal Reserve District. The *Agricultural Banker* is a monthly magazine devoted to consideration of their work and problems. The functions of such men are to service agricultural loans, to build good will, and to lend impetus to such sound agricultural programs as will assure the future agricultural

wealth of the community Farmer customers like to do business with bankers who understand and are interested in agriculture Banks with such services and qualified personnel can make a wider variety of loans to more people with less risk

Figure 116 Comment Sheet


COMMENT SHEET

NAME ______ ADDRESS ______ CREDIT LINE $ ______

F/S Dated ______
Cu A $ ______
F x A ______
Tot A ______
Cur L ______
F x L ______
Tot L ______
N/W ______
n/w

VALUE SECURITY HELD
C/Mtg dated ______ $ ______

INDEBTEDNESS
Prev ______ $ ______

DATE | COMMENTS – PURPOSE REPAYMENT PLAN – COMMITMENTS | New Loan | Tot Loan

The human element should always be recognized in agricultural lending. As is true with all people, there is a percentage of farmer borrowers who have the natural ability to become successful without any help or guidance. Contrasted to these are a comparable number of farmers who probably will not be successful regardless of the amount of assistance given them. Then, there are those who need but little help, contrasted to those who need a great deal. Between these, there is a group of farmers who, with constructive help and guidance, develop the ability to make profitable use of money borrowed.

The extent to which a country banker can, without undue risk, develop good bank customers in this group is a measure of his ability and of the value of his bank to the community. No one intentionally fails. Failures are due more to inadequate records and interpretation, which of itself is a management failure, than to lack of other abilities. With records kept up to date and with a knowledge of the results of their farming operations, farmers can either rectify their operating faults or quit farming while some part of their investment can be salvaged.

Few farmers consciously follow the businesslike policy of maintaining credit standing with their bank. While bankers cannot anticipate all customers' needs, they can maintain credit information that will contribute to this readiness to serve and often eliminate the danger of a too hasty conclusion.

Loans for various purposes, such as capital and operational, are occasionally combined, especially on renewals. This results in a confused, misleading, and often inflated condition. Operating loans should be kept separate from capital loans, since the former should be repaid from current income while the latter are usually repaid out of net income over a period of years. Notations, made on the notes themselves, of the purpose and plan of repayment serve as a reminder to the banker and evidence to the borrower that repayment is an ultimate objective.

Machinery and equipment loans are similar to other consumer loans. Instalments may be irregular in amount and in the time of payment in order to match the farm income schedule, but reduction should always be sufficient to maintain adequate equities. Dairy loans should be payable in regular instalments from dairying income. Feeding and breeder loans are payable from the sale of livestock financed or from the sale of the offspring produced. In making feeding and breeder loans, particular consideration must be given to the ability of the borrower. Pure-blooded breeding is too hazardous for the average farmer.

Real estate appraisal should be based on production from normal rota-

tion, computed at normal prices. The value of ranch land used to raise livestock should be related to the number of head of livestock that can be carried on the land and the normal value of such livestock. The requirement of periodic reduction and amortization of a loan affords protection to the bank and provides evidence of the benefits of the loan to the borrower.

Management ability is becoming increasingly important for success in farming. In the early days most of the proceeds from the products sold could be retained by the farmer or applied on his obligations. Today the operational costs of mechanized farming, hybrid seeds, disease control, higher living standards, fertilizers, and other needs materially reduce the portion of gross income available for debt payment or expansion. As the trend in that direction continues, the importance of management ability increases.

Many borrowers seem to trust to luck, to providence, and to the sympathy of their bankers for their financing needs. They apply for loans after the need has arisen, without any knowledge of their total needs and without formulating any plan of repayment. Planning is comparatively simple and is just as sound, as practical, and as possible for farmers as for businessmen. In addition to being fair to the bank, good planning and arranging for credit needs beforehand gives the borrower confidence and assurance in his operations and helps him increase his earnings.

The banker who extends credit at the beginning of the farming season or at the beginning of a program, has a moral obligation to extend the additional credit needed to complete the operation. Unless there has been a clear understanding, a "meeting of minds," at the beginning, relations may become embarrassing to both banker and customer.

Loans that increase the quality and quantity of production may be sound. Loans that merely make a task easier or shorter without increasing production are too often detrimental, and the costs of production are thereby increased unless income is left for debt payment. Character being assumed, ability is more important than security.

It is sound banking to take on new, carefully selected risks each year, thus assuring a source of successful and profitable customers in the future. It is likewise sound to eliminate those whose records indicate a lack of ambition or ability. Current and complete credit information is an aid to this end.

The sound administration of agricultural credit is both socially and materially constructive. Individuals are thereby enabled to take places of responsibility and standing in their community, to live, to think, and to

act independently, even as did those who founded and built this country. Our theory of government provides for the protection of the rights of the individual. Sound agricultural financing contributes to the welfare and independence of the individual. The country banker who thus fulfills this function thereby builds his community, protects his depositors, and assures the future of his bank.

chapter XX

LETTERS OF CREDIT AND BANKERS' ACCEPTANCES

CREDIT IS ALSO EXTENDED BY COMMERCIAL BANKS AND TRUST COMPANIES through the issuance of commercial letters of credit which are used to finance the purchase of goods by

1 A domestic importer from a foreign exporter
2 A foreign importer from a domestic exporter
3 A domestic buyer from a domestic seller

A commercial letter of credit is a special form of letter issued by a bank at a customer's request, addressed usually to a firm or an individual, and occasionally to a bank, referred to as the beneficiary, to whom authority is given to draw drafts in dollars on the issuing bank or in foreign currencies on the issuing bank's foreign bank correspondent for account of the bank's customer The letter of credit usually specifies that certain conditions are to be fulfilled by the beneficiary before he receives payment, and includes a definite commitment by the issuing bank to drawers, endorsers, and bona fide holders of drafts drawn under and in compliance with the terms of the credit, that such drafts will be honored

An Instrument of Finance The commercial letter of credit is an instrument of finance long known to international commerce It is one of the most satisfactory vehicles of credit, proven through years of usage and accepted by both buyers and sellers engaged in foreign trade MacPherson's *Annals of Commerce*, published in 1805, traces it back to the year 1202, and states that "King John, (signer of the Magna Carta), having occasion to send two agents to Rome where no business could be transacted without money, furnished them with a letter addressed to all merchants, whereby he bound himself to repay the sums advanced to his

agents to the amount of 500 marks, at such time as should be agreed upon, to any person presenting his letter together with the acknowledgement of his agents for the sums received."

The primary purpose of a commercial letter of credit is to finance a purchase of goods, and it should be clearly understood by the buyer and the seller that the purchase-sales contract executed by them is separate and distinct from the letter of credit. For example, a letter of credit does not guarantee to an American buyer that a foreign seller will abide by the terms of the purchase-sales contract, nor does it guarantee to the buyer that he will receive the merchandise he has contracted to buy. The protection given to the buyer is that the foreign negotiating bank will not pay the seller until it has received documents called for in the letter of credit, ordinarily a commercial invoice, a customs invoice, and a full set of original negotiable ocean carriers on board clean bills of lading conveying title to the merchandise, and also the assurance that all other terms of the letter of credit have been satisfied. It is, therefore, of paramount importance that the buyer obtain verification from authentic sources of the reliability and reputation of the seller in the trade before placing a letter of credit in his hands. The best sources of credit information are banks located in the vicinity of the seller and various international credit agencies.

This method of financing does not involve the actual loaning or outlay of funds by the bank. What really happens is that the name or the credit standing of the bank is loaned to the purchaser of the goods so that the seller has the promise of a widely known bank to pay his draft rather than the promise of the purchaser, who may be relatively unknown. Consequently, the seller does not rely on the buyer for payment. As a matter of fact, he may obtain payment immediately by discounting at his own bank the draft which he has drawn under the issuing bank's letter of credit. By providing the seller with a commercial letter of credit, the purchaser does not pay for his merchandise in advance. Payment is not made by the purchaser until the documents required by the terms of the letter of credit have been presented to the drawee bank, or until the acceptance, if it is a time credit, matures.

Small Banks May Use Letters of Credit

Many commercial banks and trust companies in smaller cities and towns and in the outlying districts of the larger cities lack the facilities for issuing commercial letters of credit. Letters of credit for the cus-

tomers of such banks are issued by larger correspondent banks, but under the guaranty of the smaller institution which has the account of the applicant The application for the letter of credit and the relative guaranty are signed by the bank which has the deposit account The issuing correspondent bank deals only with the smaller bank, which in turn deals with its customer, the buyer of the merchandise

Commission rates charged The bank which issues the letter of credit ordinarily will grant the guarantor bank a preferential rate of commission which is one half of its best rate charged to its prime commercial customers The correspondent bank will determine the rate of commission to be charged its customer, which will be at a higher rate than the rate it is required to pay to the issuing bank The differential between these two rates represents the profit accruing to the guarantor bank With this facility available to correspondent banks they can, if they so desire, extend to their customers letter of credit financing at commission rates comparable to those which might be obtained from a larger commercial bank, and also earn additional income for their bank

TYPES OF LETTERS OF CREDIT

There are several types of letters of credit and many possible variations of terms which contribute to make them the most flexible of the credit instruments

Irrevocable Credits

These are the best known, more frequently used and the most widely accepted because they cannot be cancelled without the mutual consent of both buyer and seller, nor can they be amended at the request of the buyer without the approval of the seller, or vice versa It is most important to specify that a letter of credit is *irrevocable,* if that is the type desired, as it is otherwise considered *revocable* in accordance with Uniform Customs and Practice for Commercial Documentary Credits fixed by the Thirteenth Congress of the International Chamber of Commerce

Revocable Credits

These are not legally binding undertakings between banks and beneficiaries Such credits may be modified or cancelled at any moment by the issuing bank without notifying the beneficiary A revocable credit

must necessarily be available for negotiation with only one specific bank, to which a copy of the original credit is transmitted by the issuing bank. Modification or cancellation of the credit can take effect only upon receipt of notification from the issuing bank by the bank with which the credit has been domiciled. Negotiations effected by the paying bank prior to the receipt of a notification of cancellation or modification must be honored by the issuing bank.

Revolving Credits

Many firms find it more convenient in certain transactions to request the issuance of revolving letters of credit which revert at certain specified intervals to the original amount of the credit. For example, a letter of credit may be revolving for the sum of \$10,000 weekly, which permits the beneficiary to draw drafts up to an aggregate of \$10,000 each week prior to the date of expiration of the credit. Credits of this type can be issued to permit drawings daily, weekly, monthly, or for any period desired by the buyer. Revolving credits may be cumulative or non-cumulative.

Cumulative Credits. In a cumulative credit under which the amount of \$10,000 revolves weekly, any sum not used by the beneficiary in each specified period *may be drawn* in any subsequent period. For example, if only \$6,000 were drawn in one of the weekly periods, any part or all of the unused portion of \$4,000 could be utilized in any subsequent period.

Non-Cumulative Credits. In a non-cumulative credit, any amount not used by the beneficiary during each specified period *may not* be drawn in any subsequent period. Using the same illustration—if only \$6,000 were drawn in one weekly period, the unused portion of \$4,000 could not be utilized in a later period. Unless a customer possesses substantial resources, a revolving credit is issued in revocable form since it can be appreciated that an irrevocable credit revolving weekly in an amount of \$10,000 would obligate a bank to an aggregate amount of \$520,000 if the expiration date of the credit were a year from the date of issuance. Firms, such as mail order houses or department stores, utilizing a revocable revolving letter of credit, often name a foreign buying agent as the beneficiary whom they have commissioned to purchase various types of merchandise. If the importer is dissatisfied for any reason, he can request the issuing bank to notify the foreign bank at which the credit is available either to reduce the amount revolving or to cancel the credit

immediately on receipt of the notification which can be dispatched either by cable or air mail, depending on the urgency of the situation

Assignable Credits

It often happens that the beneficiaries of both domestic and import letters of credit are not actually the suppliers or manufacturers of the goods desired by the buyers In such cases the sellers request the buyers to instruct their bankers to issue letters of credit which can be assigned to a third party or directly to a bank This may be accomplished by the issuing bank by adding the words 'or Assigns' following the name and address of the beneficiary Whenever the original beneficiary assigns the letter of credit to a third party, he advises the issuing bank of his action giving the name of the assignee and the amount assigned if only a partial assignment is made Bankers ordinarily derive an assignment commission from the beneficiary for effecting the assignment Proper notations are made in the banks records and drafts accompanied by the required documents may then be drawn and presented for payment by the assignee

The bank which issues the letter of credit, however, assumes no responsibility for the proper identity of the assignee or the validity of any assignment This is covered by a rider attached to the guaranty addressed to the bank and signed by the buyer and reads substantially as follows

To THE FIRST NATIONAL BANK OF CHICAGO

With reference to your letter of credit No G C 36000 a copy of which is attached, at our special request there has been added the words "or assigns" to the designated beneficiary, and it is understood and agreed that you are under no duty to determine the proper identity of any one appearing in the draft or documents as assignee, nor shall you be charged with responsibility of any nature or character for the validity or correctness of any assignment or successive assignments and that payment by you to any purported assignee or assignees as determined by you, is hereby authorized and approved and further the undersigned agrees to hold you harmless and indemnified against any liability or claim in connection with or arising out of the foregoing

American Importing Company
By John Smith, Treasurer
Authorized Official Signature

Special Credits

In some instances, firms send their own representatives to various countries on purchasing missions and wish them to be in a position to make payments directly to suppliers for merchandise purchased or to arrange with a foreign bank to pay directly to foreign sellers specific amounts against delivery of stipulated documents. Since the firm does not know in advance from whom the purchases may be made, the representative may be provided with a letter of credit issued in his favor or assigns. For purposes of identification, the issuing bank furnishes the representative with a separate letter of introduction on which a specimen of his signature appears.

This type of letter of credit usually stipulates that drafts need only be accompanied by a statement signed by the representative to the effect that the funds will be used for the payment of merchandise or by such other documents as may be designated by the representative. If the representative wishes to obtain funds, he negotiates drafts accompanied by his signed statement only. If the representative has effected purchase orders with certain suppliers, he may assign the letter of credit, all or in part, depending on the amounts of the contracts, to the sellers and designate in the assignment the shipping documents the sellers must submit to the foreign bank to which the arrangements would be known before payment could be made to the sellers.

BASES OF CREDIT EXTENSION

Banking institutions issue import letters of credit for account of business enterprises, individuals and customers of their domestic bank correspondents. The basis on which letters of credit are issued depends upon the financial condition and the credit standing of the importer.

Unsecured Credit. If there is no doubt about the credit worthiness of the customer, the letter of credit is issued on an unsecured basis.

Secured Credit. If the extension of credit is not warranted, the importer may either put up *cash* for the face amount of the letter of credit or pledge *marketable securities.* Occasionally an issuing bank will learn of an impairment of the importer's financial condition subsequent to the issuance of a letter of credit. In that case the bank protects itself by retaining the documents negotiated under the letter of credit and authorizing the custom house broker, who receives a set of documents, to handle the shipment for account of the bank. When the shipment arrives,

the bank may instruct the custom house broker to warehouse the goods in its name and deliver the *warehouse receipt* to it. As the customer sells the merchandise he presents the sales orders to the bank which authorizes the warehouse to allow partial withdrawals and release the relative merchandise to the customer against a trust receipt. When the customer receives proceeds of the sale, he pays the bank and redeems the trust receipt which he signed.

Back to Back Credits. A bank also accepts as collateral for the issuance of a letter of credit a commercial letter of credit which either the bank itself has issued or which some other bank may have issued in favor of the bank's import customer. In such cases, both letters of credit must finance the purchase of the same merchandise. Letter of credit A covers the purchase of specific merchandise by a business enterprise or an individual, whereas letter of credit B, which is assigned as security, covers the sale of the same merchandise by the bank's customer to the party for whose account the assigned letter of credit B was issued. The bank which issued the letter of credit A is, therefore, protected by the guaranty of the bank which issued the letter of credit B, but the former bank must be certain that the documents required by the terms of letter of credit A comply absolutely with the conditions outlined in the assigned letter of credit B. Letter of credit B should be an assignable credit, a description of which was outlined in a preceding paragraph.

ILLUSTRATION OF IMPORT LETTER OF CREDIT TRANSACTION

An actual transaction will be presented to illustrate the manner in which a customer applies to his bank for a letter of credit. The importer, in this case, the American Importing Company of Chicago, Illinois, has agreed to purchase from the Brazilian Coffee Company of Santos, Brazil, 500 bags of coffee at 34 cents per pound, landed at New Orleans, Louisiana.

Application Form

The importer prepares an application form (Figure 117) which shows the major terms of the purchase sales contract and the information necessary for the bank to issue the letter of credit. An explanation of several of the terms follows.

Tenor of Draft. In order that the importer may have time to process the coffee, if he is a roaster, or sell the green coffee, if he is a broker, the

seller has agreed to allow ninety days after the acceptance of the draft by the issuing bank before payment becomes due. The bank is therefore advised in the application that drafts are to be drawn at ninety days sight.

Invoice showing. The coffee shipper has agreed to sell the coffee at 34 cents per pound, which includes the cost (C) of the coffee and the freight (F) from any port in Brazil to the port of New Orleans. There-

Figure 117 Application Form for Commercial Letter of Credit

APPLICATION FOR COMMERCIAL LETTER OF CREDIT FROM

G. C. No. 36000 Date June 1, 19

SPECIMEN

THE FIRST NATIONAL BANK OF CHICAGO
CHICAGO 90, ILLINOIS

Please issue an irrevocable Letter of Credit as set forth below and upon issuance of credit you are hereby instructed to transmit it by ☐ mail ☒ airmail ☐ cable ☒ to your correspondent for delivery to the beneficiary ☐ to us.

Amount - - - -	$22,440.00
In favor of - - -	Brazilian Coffee Company, Santos, Brazil
Tenor of Draft -	Ninety days sight
For account of - -	American Importing Company, Chicago, Illinois
Invoice Showing -	500 Bags of coffee at 34 cents per pound C. & F. New Orleans, Louisiana.
B/L Issued to order of	shipper, endorsed in blank
Notify - - - -	The Louisiana Forwarding Company, New Orleans, Louisiana
Shipment From -	Brazil
Shipment To - -	New Orleans, Louisiana
Expiration Date -	July 1.
Documents for Custom House Broker are to be sent by First Negotiating Bank To—	The Louisiana Forwarding Company, New Orleans, Louisiana

Insurance (Indicate by "X")
☐ Certificate must accompany Draft
☒ Effected by Buyer. We agree to keep insurance coverage in force until the transaction is completed.

Documents Required to be indicated by "X"

X	Commercial Invoices
X	U S Customs Invoices
X	Ocean Carriers on Board Clean B/L
	Ocean Carriers Clean B/L
	Railroad Clean B/L

	Clean B/L
	Parcel Post Receipt
	Forwarding Agents Receipt
	Statement

Certificates
Quality
Weight
Origin

Insurance
Marine
War Risk

Unless otherwise instructed partial shipments will be permitted under this credit

☒ Partial Shipments not permitted

Special Instructions:

LIABILITY	APPROVED
ACCEPTANCE	Release Documents
CONTINGENT	
ADVANCES	Held Documents
ACCEPTANCES EXECUTED FOR OTHER CUSTOMERS	Division
TOTAL	

PLEASE DATE AND OFFICIALLY SIGN AGREEMENT AT FOOT OF PAGE 4

Page 1

fore, the invoice submitted by the shipper must show the quantity of coffee sold, the price per pound and the selling terms indicated—C & F New Orleans

B/L issued to order of The B/L or bill of lading called for may be issued by the ocean carrier to the order of the shipper and endorsed in blank This document controls the shipment and is, of course, the most important and valuable of the required documents called for in the application Since the bill of lading is endorsed in blank, it is good in anyone's hands, similar to a check or draft endorsed in blank by the payee It is the usual custom of steamship companies to issue bills of lading in sets of two, three and sometimes four originals—any one of which being used the remaining stand void Should the issuing bank extend unsecured credit to the importer but still wish to retain control of the merchandise, it would advise the customer that it wishes bills of lading issued to its order If the credit standing of the importer is undoubted, the bank would be quite willing to have bills of lading issued to the order of the customer Straight bills of lading are usually not acceptable on import shipments, particularly to the issuing banks, because they prefer control of the merchandise to rest with the holder of an order bill of lading, be it the bank itself, its own customer or the custom house broker The undesirable feature of a straight bill of lading is that the document itself does not control the shipment and does not have to be presented to the steamship company in order to obtain the merchandise The merchandise may be delivered on the recognizance of the importer or the custom house broker claiming to represent the importer

Notify The "notify party" shown in the bill of lading is usually the custom house broker or the importer Frequently the importer does not wish it to be known by his competitors or the business public in general that he is importing merchandise By having the custom house broker shown as the "notify party" the importer's identity is not revealed Both the broker and the importer are often shown as the "notify party" In any event, the steamship company notifies the designated party or parties of the arrival of the shipment at the port of destination

Shipment From In order that the seller may ship the merchandise by the first available steamer, it is usually agreed by the buyer and seller that no port of departure be specified—only the country is named

Expiration Date The importer is interested in the date the relative merchandise will be delivered at his plant, which in this instance might be approximately August 1 Estimating the transit time from Brazil to Chicago via New Orleans to be about one month, he sets the expiration

date at July 1. This forces the seller to deliver the merchandise to the steamship company in exchange for the full set of bills of lading, prepare the other documents called for in the letter of credit, including the ninety day sight draft, and present the draft, documents and the original letter of credit to his bank for negotiation on or before July 1.

Insurance. American importers have found it generally preferable to insure the merchandise with an American marine insurance company. In the event a claim for loss or damage must be made, the proximity of an American insurance company is advantageous in filing claims and recovering reimbursement.

U. S. Customs Invoice. This document is prepared by the shipper on a form supplied by the U. S. Customs Service and when completed is submitted to the U. S. consular office in the country of origin to be consularized. Although coffee is not subject to duty in the United States, consularization of the document is required principally to permit the consular office to confirm that the product has been grown in the country from which it is being shipped and also to verify that the selling price shown in the invoice coincides with the relative market price for the grade and size being shipped.

Partial Shipments Not Permitted. It is ordinarily understood that partial shipments *will be permitted* unless otherwise indicated in the terms of the letter of credit. In this case, the importer has indicated that only one shipment of the entire lot of 500 bags may be made.

Authorized Signature. It is important that the application be signed by a member of the importing firm who is authorized to apply for letters of credit. After the importer has completed the application form, he signs it officially and submits it to the issuing bank with the request that it be prepared.

PREPARATION OF IMPORT LETTER OF CREDIT

When the issuing bank receives an officially signed application for an import letter of credit from its customer, which form combines the request for the letter of credit and the guarantee form thereunder, it utilizes the details in the application and prepares an original letter of credit (Figure 118). In the same typing operation, the original credit and non-negotiable copies are prepared and also a ledger sheet which becomes a part of the issuing bank's records. Certain details concerning every negotiation are noted on the ledger sheet; such as the amount and date of draft and any other pertinent facts. All amendments to the credit are also

recorded Not infrequently documents other than those mentioned in this particular transaction are required such as certificates of quality, origin and weight, or parcel post receipts The documents required are always indicated by the purchaser in the application for the letter of credit

Figure 118 Issuing Bank s Original Commercial Letter of Credit

No. G C 36000 Irrevocable U S $ 22,440 00

THE FIRST NATIONAL BANK OF CHICAGO

CHICAGO 90 ILLINOIS

Brazilian Coffee Company
Santos Brazil

SPECIMEN

GENTLEMEN

WE HEREBY AUTHORIZE YOU TO DRAW ON THE FIRST NATIONAL BANK OF CHICAGO AT ninety days SIGHT FOR ANY SUM OR SUMS NOT EXCEEDING IN ALL Twenty Two Thousand Four Hundred Forty U S Dollars

FOR ACCOUNT OF American Importing Company, Chicago, Illinois

Draft is to be accompanied by Commercial invoices showing 500 bags of coffee at 34 cents per pound C & F New Orleans Louisiana U S customs invoices and full set of ocean carriers on board clean bills of lading issued to order of shipper endorsed in blank, notify The Louisiana Forwarding Company New Orleans Louisiana showing shipment from Brazil to New Orleans Louisiana

Partial shipments not permitted

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THIS CREDIT WILL REMAIN IN FORCE UNTIL July 1, AND DRAFTS MUST BE NEGOTIATED ON OR BEFORE THAT DATE

THE FIRST NEGOTIATING BANK MUST ATTACH ONE ORIGINAL BILL OF LADING AND COMMERCIAL INVOICE TO EACH DRAFT AND MUST FORWARD THE REMAINING DOCUMENTS

TO The Louisiana Forwarding Company, New Orleans, Louisiana

FOR ACCOUNT OF THE FIRST NATIONAL BANK OF CHICAGO A CERTIFICATE OF THE FIRST NEGOTIATING BANK THAT DOCUMENTS HAVE BEEN FORWARDED AS DESIGNATED MUST ACCOMPANY EACH DRAFT

WE HEREBY AGREE WITH DRAWERS, ENDORSERS AND BONA FIDE HOLDERS OF DRAFTS NEGOTIATED UNDER AND IN COMPLIANCE WITH THE TERMS OF THIS CREDIT THAT THE SAME SHALL BE DULY HONORED UPON PRESENTATION AT THE COUNTER OF THE FIRST NATIONAL BANK OF CHICAGO EACH AMOUNT DRAWN MUST BE ENDORSED ON THE REVERSE HEREOF BY THE NEGOTIATING BANK

INSURANCE Effected by Buyer

DRAFTS UNDER THIS CREDIT MUST BEAR UPON THEIR FACE THE WORDS
DRAWN UNDER THE FIRST NATIONAL BANK OF CHICAGO
CREDIT NO G C 36000 DATED June 1,

RESPECTFULLY YOURS

THE FIRST NATIONAL BANK OF CHICAGO

After the letter of credit has been prepared, the bank follows the instructions of the importer indicated on the application form as to the disposition of the original credit. The requested number of non-negotiable copies of the letter of credit are forwarded to the importer. A non-negotiable copy of the credit is forwarded to the foreign bank together with the original credit for eventual dilivery to the beneficiary.

Liability of Customer and Bank

Because there is no actual outlay of funds involved in the issuance of a commercial letter of credit, there is no direct liability outstanding while a letter of credit is unused. There is, however, a contingent liability. Accordingly, the amount of each letter of credit issued is charged to a special contingent liability account. As soon as a draft has been paid under a sight letter of credit, the contingent liability account is reduced accordingly. On letters of credit which have expired, the liability may be cancelled, after allowing a reasonable length of time for any items which may be in transit to be presented to the issuing bank.

As soon as a draft has been accepted under a time letter of credit, the contingent liability is reduced accordingly. There is then immediately created a direct liability which both the accepting bank and the customer are obligated to pay. The amount of the acceptance is consequently charged into a special liability account maintained for that purpose. When the acceptance is later paid, the direct liability is reduced. Actually, there are two acceptance liability accounts set up on the books. The liability of the bank as acceptor appears in the liabilities on the bank's statement, while the liability of the customer as guarantor appears in the assets on the bank's statement. Individual records are also kept of each customer's contingent and acceptance liability under commercial letters of credit.

Customer's Guaranty. For each letter of credit issued, the bank obtains from the customer a guaranty on a printed form (Figure 119). This guaranty covers the customer's agreement to reimburse the bank for drafts drawn under the letter of credit, to pay the bank a commission, and to hold the merchandise or proceeds thereof at the disposal of the bank pending full settlement. The guaranty provides further that the customer will not hold the bank responsible for the genuineness of the documents, or for the quantity, quality, or character of the merchandise described in the documents.

Bank's Commission. When a bank loans its funds, it is remunerated by

charging interest to the borrower However, since no cash is advanced in preparing and opening a letter of credit, the bank receives its compensation or consideration for loaning its name by charging the customer a commission at the time a draft is paid The commission is figured on an interest basis and is computed according to the tenor of the draft drawn under the letter of credit Each bank follows its own policy with regard to the rate charged In most banks, importers who warrant the prime loaning rate should receive the best commission rate charged on letters of credit This rate is ordinarily lower than the rate on a commercial loan The lowest commission rate charged on sight letters of credit is usually ⅛ of 1% with a minimum charge of $10 00 whether the credit is used or not The following figures illustrate the commission rates charged on dollar letters of credit when the customer is charged on a basis of 1½ per cent per annum

Drafts at sight	⅛%	of the face amount of the draft
" " 30 days' sight	⅛%	" " " " " " "
" " 60 " "	¼%	" " " " " " "
" " 90 " "	⅜%	" " " " " " "

On a *foreign currency credit* under which the beneficiary draws drafts expressed in the currency of his country, commission rates applied by the issuing bank include the charges made by the bank's foreign correspondent for inspecting documents to ascertain that the beneficiary has complied with the terms of the credit, for making payments to the beneficiary and, in the case of time drafts, for an acceptance commission Rates for foreign currency credits vary between different countries, depending on the foreign bank charges, but usually are more than those for dollar credits

Figure 119 Guaranty Given to Issuing Bank (*officially signed by the importer or by the domestic bank correspondent*)

TERMS AND CONDITIONS OF COMMERCIAL LETTER OF CREDIT AND SECURITY AGREEMENT

In consideration of your issuing the Credit, substantially according to the Application appearing on the reverse side hereof or as attached thereto and initialled by us, we, the undersigned, hereby jointly and severally agree as follows

1. As to drafts or acceptances under or purporting to be under the Credit, which are payable in United States Dollars, we agree (a) in the

case of each sight draft, to reimburse you at your office, on demand, in legal tender of the United States of America, the amount paid on such drafts, or, if so demanded by you, to pay you at your office in advance in legal tender of the United States of America the amount required to pay such draft; and (b) in the case of each acceptance, to pay to you at your office, in legal tender of the United States of America, the amount thereof, on demand but in any event not later than the date of maturity.

2. As to drafts or acceptances under or purporting to be under the Credit which are payable in currency other than United States Dollars we agree: (a) in the case of each sight draft, to reimburse you at your office, on demand, the equivalent of the amount paid, in legal tender of the United States of America at the rate of exchange then current in Chicago for cable transfers to the place of payment in the currency in which such draft is drawn, with interest from the date of payment of the instrument, or if so demanded by you, to pay you, at your office in advance, in United States currency, the equivalent of the amount required to pay the same; and (b) in the case of each acceptance, to pay you at your office, on demand, the equivalent of the acceptance in the legal tender of the United States of America at the current rate of exchange for demand drafts on the place of payment, if payment is made by us in time to reach the place of payment in the course of the mails not later than the date of maturity, or at the current rate in Chicago for cable transfers at time of transmission to the place of payment in the currency in which the acceptance is payable, if such payment is made at your office on the maturity date. If, for any cause whatsoever, there exists at the time in question no rate of exchange generally current in Chicago for effective cable transfers of the sort above provided for, we agree to pay you on demand an amount in United States Dollars equivalent to the actual cost of settlement of your obligation to the payor of the draft or acceptance or any holder thereof, as the case may be, and however and whenever such settlement may be made by you, including interest on the amount of dollars payable by us from the date of payment of such draft or acceptance to the date of our payment to you at the rate customarily charged by you in like circumstances.

3. In the event that any United States Dollar drafts are drawn by us on you in order to refinance any obligation set forth in the preceding two sections, and such drafts, at your option, are accepted by you, we agree to pay you on demand, but in any event not later than the maturity date the amount of each such acceptance. Each amount which may become due and payable to you under this Agreement may, in your discretion and if not otherwise paid, be charged by you to any available funds then held by you for our account.

4 We agree to pay you on demand, with respect to the Credit, a commission at such rate as you may determine to be proper, and any and all charges and expenses which may be paid or incurred by you in connection with the Credit, together with interest where chargeable Interest payable hereunder shall be at the rate customarily charged by you at the time in like circumstances

5 As security for all of our obligations and liabilities to you, we hereby recognize and admit your security interest in all property shipped under or pursuant to or in connection with the Credit or in any way relative thereto or to the drafts drawn thereunder, whether or not released to us or to our agents on security agreements, and also in and to all shipping documents, warehouse receipts, policies or certificates of insurance and other documents accompanying or relative to drafts drawn under or in connection with the Credit, and in and to the proceeds of each and all of the foregoing, until such time as all the obligations and liabilities of us or any of us to you at any time existing under or with reference to the Credit or this agreement, or any other obligation or liability to you have been fully paid and discharged, and that all or any of such property and documents, and the proceeds of any thereof, coming into your possession or that of any of your correspondents, may be held and disposed of as hereinafter provided You shall have all of the rights of a secured party under the Uniform Commercial Code in the aforesaid property and, in addition, shall have all of the rights specified herein We agree to execute such financing statements and other writings as shall be necessary to perfect and maintain your security interest in all said property and to pay all costs of filing financing, continuation and termination statements with respect to your security interest hereunder The receipt by you or any of your correspondents at any time of other security of whatsoever nature, including cash, shall not be deemed a waiver of any of your rights or powers herein recognized

6 In the absence of written instructions expressly to the contrary, we agree that you or any of your correspondents may receive and accept as "bills of lading" under the Credit, any document issued or purporting to be issued by or on behalf of any carrier, which acknowledges receipt of property for transportation, whatever the other specific provisions of such document(s), and that the date of each such document shall be regarded as the date of shipment of the property mentioned therein Any such bill of lading issued by or on behalf of an ocean carrier may be accepted by you as an "ocean bill of lading" whether or not the entire transportation is by water. Unless otherwise specifically agreed in writing, partial shipments may be made and you may honor the relative drafts, our liability to reimburse you for payments made or obligations incurred on such drafts

being limited to the amount of the Credit. If the Credit specified shipments in installments within stated periods, and the shipper fails to ship in any designated period, shipment of subsequent installments may nevertheless be made in their respective designated periods, and you may honor the relative drafts. You and any of your correspondents may receive and accept as documents of insurance under the Credit either insurance policies or insurance certificates which need not be for an amount of insurance greater than the amount paid by you under or relative to the Credit. You and any of your correspondents may receive, accept, or pay as complying with the terms of the Credit, any drafts or other documents, otherwise in order, which may be signed by, or issued to, the administrator or executor of, or the trustee in bankruptcy or the receiver for any of the property of, the party in whose name it is provided in the Credit that any drafts or other documents should be drawn or issued.

7. We agree that in the event of any extension of the maturity or time for presentation of drafts, acceptances, or documents, or any other modification of the terms of the Credit, at the request of any of us, with or without notification to the others, or in the event of any increase in the amount of the Credit at our request, this Agreement shall be binding upon us with regard to the Credit so increased or otherwise modified, to drafts, documents, and property covered thereby, and to any action taken by you or any of your correspondents in accordance with such extension, increase, or other modification.

8. The users of the Credit shall be deemed our agents and neither you nor your correspondents shall be responsible for: (a) the use which may be made of the Credit or for any acts or omissions of the users of the Credit; (b) the existence of the property purporting to be represented by documents; (c) any difference in character, quality, quantity, condition, or value of the property and that purporting to be represented by documents; (d) the validity, sufficiency, or genuineness of documents, even if such documents should in fact prove to be in any or all respects.invalid, fraudulent, or forged; (e) the time, place, manner or order in which shipment is made; (f) partial or incomplete shipment, or failure or omission to ship any and all of the property referred to in the Credit; (g) the character, adequacy, validity, or genuineness of any insurance, the solvency or responsibility of any insurer, or any other risk connected with insurance; (h) any deviation from instructions, delay, default, or fraud by the shipper or any one else in connection with the property or the shipping thereof; (i) the solvency, responsibility, or relationship to the property of any party issuing any documents in connection with the property; (j) delay in arrival or failure to arrive of either the property or any of the documents relating thereto; (k) delay in giving or failure to give notice

of arrival or any other notice, (l) any breach of contract between the shippers or vendors and ourselves or any of us, (m) failure of any instrument to bear any reference or adequate reference to the Credit, or failure of documents to accompany any draft at negotiation, or failure of any person to note the amount of any draft on the reverse of the Credit or to surrender or to take up the Credit or to send forward documents apart from drafts as required by the terms of the Credit, each of which provisions, if contained in the Credit itself it is agreed may be waived by you (n) errors omissions interruptions or delays in transmission, or delivery of any messages by mail, cable, telegraph, wireless or otherwise whether or not they may be in cipher You shall not be responsible for any act, error neglect, or default, omission, insolvency or failure in the business of any of your correspondents or for any refusal by you or any of your correspondents to pay or honor drafts drawn under the Credit because of any applicable law decree or edict, legal or illegal, of any governmental agency now or hereafter in force or for any matter beyond your control The happening of any one or more of the contingencies referred to in the preceding clauses of this paragraph shall not affect, impair or prevent the vesting of any of your rights or powers hereunder, or our obligation to make reimbursement. In furtherance and extension and not in limitation of the specific provisions hereinabove set forth, we agree that any action taken by you or by any correspondent of yours under or in connection with the Credit or the relative drafts documents, or property if taken in good faith, shall be binding on us and shall not put you or any of your correspondents under any resulting liability to us and we make like agreement as to any inaction or omission unless in breach of good faith.

9 If it is a condition of this Credit that the accreditees are authorized to draw clean drafts, you are authorized and instructed to accept and pay drafts without requiring and without responsibility for the delivery of shipping documents either at the time of acceptance or of payment or thereafter

10 We agree to procure promptly any necessary import and export or other licenses for the import, export, or shipping of the property and to comply with all foreign and domestic governmental regulations in regard to the shipment of the property or the financing thereof, and to furnish such certificates in that respect as you may at any time require, and to keep the property adequately covered by insurance acceptable to you, and to assign the policies or certificates of insurance to you, or to make the loss or adjustment, if any, payable to you, at your option, and to furnish you if demanded, with evidence of acceptance by the insurers of such assignment.

Figure 119 (*Continued*)

11. In the event you deliver to us, or to any of us, or to a Custom House Broker at our request any of the documents of title pledged hereunder prior to having received payment in full of all of our liabilities to you, we agree to obtain possession of any goods represented by documents within twenty-one days from the date of such delivery of said documents and if we should fail to do so, we agree to return said documents or to have them returned by the Custom House Broker to you prior to the expiration of the said twenty-one day period. We agree to execute and deliver to you receipts for such documents and the goods represented thereby identifying and describing such documents and goods, which said receipts shall constitute a part of this Agreement.

12. Each of us agrees at any time and from time to time, on demand, to deliver, convey, transfer, or assign to you, as security for any and all of his and/or our obligations and liabilities, contingent or absolute, due or to become due, which are now or may at any time hereafter be owing by him or us to you, additional security of a character and value satisfactory to you, or to make such payment as you may require. Each of us agrees that all property belonging to him, or us, in which he or we may have an interest, of every name and nature whatsoever, now or at any time hereafter delivered, conveyed, transferred, assigned, or paid to you, or coming into your possession in any manner whatsoever, whether expressly as security for any of the obligations or liabilities of him or us to you, or for safekeeping or otherwise, including any items received for collection or transmission and the proceeds thereof, whether or not such property is in whole or part released to us on security agreement, are hereby made security for each and all such obligations and liabilities.

13. Each of us agrees that upon his or our failure at any time to keep a margin of security with you satisfactory to you, or upon the making by him or us of any assignment for the benefit of creditors, or upon the filing of any voluntary or involuntary petition in bankruptcy by or against him or us, or upon the application for the appointment of a receiver of any of his or our property, or upon any act of insolvency of him or us, all of such obligations and liabilities shall become and be immediately due and payable without demand or notice, notwithstanding any credit or time allowed to him or us, or any instrument evidencing any such obligations or liabilities or otherwise. Each of us, as to property in which he may have any interest, and all of us, as to property in which we may have any interest expressly authorize you in any such event, or upon his failure to pay any of such obligations or liabilities when it or they shall become or be made due, to sell immediately, without demand for payment, without advertisement and without notice to us or any of us, all of which are

hereby expressly waived, any and all such property, arrived or to arrive, at private sale or at public auction or at broker's board or otherwise, at your option, in such parcel or parcels and at such time or times and at such place or places and for such price or prices and upon such terms and conditions as you may deem proper, and to apply the net proceeds of such sale or sales, together with any balance of deposits and sums credited by or due from you to him or us in general account or otherwise, to the payment of any and all of such obligations or liabilities to you however arising If any such sale be at broker's board or at public auction, you may yourself be a purchaser at such sale, free from any right of redemption which we hereby expressly waive and release

14 The rights and liens which you possess hereunder shall continue unimpaired, and we and each of us shall remain obligated in accordance with the terms and provisions hereof, notwithstanding the release or sub stitution of any property which may be held as security hereunder at any time, or of any right or interest therein No delay, extension of time, renewal, compromise or other indulgence which may occur, shall impair your rights or powers hereunder You shall not be deemed to have waived any of your rights hereunder unless you or your authorized agent shall have signed such waiver in writing No such waiver, unless expressly as stated therein, shall be effective as to any transaction which occurs subsequent to the date of such waiver, nor as to any continuance of a breach after such waiver

15 Except as otherwise expressly provided in this Application and Agreement or as you and we may otherwise expressly agree with regard to, and prior to your issuance of the Credit, or insofar as they may be contrary to statute, the "Uniform Customs and Practice for Commercial Documentary Credits Fixed by the Thirteenth Congress of the International Chamber of Commerce" shall apply to the Credit and shall serve, in the absence of proof expressly to the contrary, as evidence of general banking usage

16 The word "property" as used herein includes goods and merchandise, as well as any and all documents relative thereto, also, securities, funds, choses in action, and any and all other forms of property, whether real, personal or mixed and any right or interest therein

17 This Agreement shall be binding upon us, our heirs, executors, administrators, successors, and assigns and shall inure to the benefit of, and be enforceable by you, your successors, transferees, and assigns If this Agreement should be terminated or revoked as to us by operation of law, we will indemnify and save you harmless from any loss which may

be incurred by you in acting hereunder prior to the receipt by you or your successors, transferees, or assigns of notice in writing of such termination or revocation. If this Agreement is signed by one individual, the terms "we," "our," "us," shall be read throughout as "I," "my," "me," as the case may be. If this Agreement is signed by two or more parties, it shall be the joint and several agreement of such parties; and in any such case, this Agreement shall not be revoked or impaired as to any one or more of such parties by the death of any of the others or by the revocation or release of any obligations hereunder of any one or more of such parties.

18. This Agreement and all rights, obligations, and liabilities arising hereunder shall be governed by, and construed in accordance with, the laws of the State of Illinois.

Very truly yours,
American Importing Company

by: John Smith
Official Signature
Treasurer

Date June 1,

Address: 2020 West 20th Street
Street

Chicago	Cook	Illinois
City	County	State

Broker's Notice

Simultaneously with the issuance of the import letter of credit, the issuing bank advises the custom house broker, the Louisiana Forwarding Company, New Orleans, Louisiana, of the issuance of the letter of credit in the form of a broker's notice (Figure 120). In the notice, the bank gives all the information which the broker needs to know regarding the letter of credit. Most important of all are the instructions given to the broker as to the manner in which the property is to be handled and from whom the broker is to take instructions. In the illustration cited, the bank has extended unsecured credit to the American Importing Company and is perfectly willing for the broker to take instructions from that company. However, if the bank were not impressed with the financial condition of the importing company and had extended credit on a secured basis, it would instruct the broker to take instructions as to the

disposition of the property from the bank itself Although the custom house broker has been employed by and will be paid by the importer for his services, he will have no objection in following the instructions of the bank which are contained in the broker's notice

Figure 120 Issuing Bank's Advice to Custom House Broker

FBDM

The First National Bank of Chicago

CHICAGO 90 ILLINOIS

INTERNATIONAL BANKING DEPARTMENT

DATE June 1 19

The Louisiana Forwarding Company
New Orleans, Louisiana

We have issued our Commercial Letter of Credit

No G C 36000 for $22,440.00 in favor of

Brazilian Coffee Company, Santos, Brazil

on behalf of American Importing Company, Chicago, Illinois, covering shipment of coffee

and have directed that the Bills of Lading be sent to you for account of The First National Bank of Chicago for Custom House shipping purposes

Unless you have been otherwise instructed by us the property covered by above named documents is to be handled in accordance with instructions which you should obtain from American Importing Company Chicago Illinois

Kindly acknowledge receipt by signing and returning the attached copy

Yours respectfully

SPECIMEN

Per Pro Vice-President

Forwarding the Completed Credit

There are differences of opinion as to the best procedure to follow in placing the completed commercial letter of credit in the hands of the beneficiary

Credit forwarded by customer. Some customers insist on forwarding the letter of credit directly to the beneficiary themselves, including in their correspondence a signed copy of the purchase sales contract and any other information pertinent to the transaction.

Banks provide delivery service. The majority of international bankers, however, provide a very convenient service for their customers by offering to deliver the original letter of credit to the beneficiary through the medium of their foreign bank correspondent.

Hazards of delivery service. This procedure, of course, places the responsibility of delivery directly on the issuing bank; however, should delivery of the letter of credit not be effected in accordance with the terms of the purchase sales contract, that is on or before a specified date, the beneficiary could claim breach of contract and refuse to ship the merchandise.

Possibility of lawsuits. This could cause further repercussions and result in a lawsuit against the issuing bank initiated by the import customer who might have suffered damages in not receiving the merchandise and he himself might be forced to default on contracts with other firms to which he had agreed to deliver a part of the merchandise comprising his import shipment. Thus, the importer could also become a defendant in one or more lawsuits due to his failure to deliver. This hazard has not deterred issuing banks from continuing to offer the service because of the infrequency of such situations.

Bank benefits in delivering credit. The advantage accruing from the equitable distribution of their letter of credit business to designated bank correspondents by the issuing bank apparently outweighs the risk of nondelivery of the original letter of credit to the beneficiary.

Credits opened by cable. If urgency is a factor, the importer indicates on the application that he would like to have the terms of the letter of credit cabled. In the latter event, the issuing bank cables the terms of the letter of credit to its foreign correspondent bank nearest the domicile of the beneficiary. The foreign bank advises the terms of the letter of credit by mail directly to the beneficiary and in the meantime the issuing bank forwards a confirmation of the cable and a copy of the letter of credit for the foreign advising bank's files. Practices amongst issuing banks vary —some issue an original letter of credit indicating on the face that the terms of the credit were originally advised by cable; others do not, as they consider that the cable advice and their confirmation suffice.

Amendments to Original Credit. Frequently amendments of the terms of the original letter of credit are requested by the beneficiary and oc-

casionally by the importer Perhaps an extension of the expiration date needed by the shipper because of delays in manufacture or difficulties procuring the commodity financed by the credit Inability to obtain shi ping space on the steamer originally chosen and the necessity of selecti a ship which sails after the expiration date of the credit forces the shi per to request an extension The importer often increases his origir purchase order and requests the issuing bank to raise the amount of t credit to cover His plans also may be altered through cancellations orders received from the end users and the subsequent sale of the produ financed to a firm located in another section of the country This situ tion could result in an amendment of the credit changing the destinati of the shipment to the port of Chicago instead of New Orleans

After the issuing bank receives written instructions from the ir porter to amend the credit, the bank prepares a letter of amendment a dressed to the beneficiary Delivery is accomplished in the same mann as the original credit If the credit was opened by cable through a fo eign correspondent bank and urgency is a factor, the amendment m also be advised by wire Otherwise, an airmail advice of amendment forwarded, either by the importer directly to the beneficiary or throu the medium of the foreign bank by the issuing bank, and is attached the original credit by the beneficiary

The issuing bank prepares a supplementary guaranty containing t details of the amendment and the agreement of the guarantor that oth conditions in the original credit remain unchanged The supplementa guaranty is signed officially by the importer and returned to the banl

Beneficiary s Use of Credit

When the credit is received by the beneficiary, it becomes an expo letter of credit The exporter, desiring to obtain reimbursement as quick as possible, takes the first step, assuming that the merchandise is ready f shipment

Procurement of bill of lading A freight forwarder is requested to c for the merchandise at the place of business of the beneficiary and c liver it to the ocean carrier, obtaining in exchange the steamship co pany's receipt in the form of an ocean carriers on board clean bill lading In the illustration used in Figure 118, the bill of lading, or bladir (an abbreviated term used in the trade), must show 500 bags of coff to be shipped from a port in Brazil to the port of New Orleans, Loui ana Since the credit also calls for a *clean* blading, there can be no clau

placed on the document by the steamship company indicating that the merchandise or the receptacles said to contain the merchandise were received in other than apparent good condition. A claused blading is not clean.

Forwarding agents receipt. In the event a shipment originates with a shipper at an inland point, some beneficiaries insist that the letter of credit provide that payment be made against a forwarding agent's receipt. The forwarder would be given instructions by the beneficiary to ship the merchandise from the inland point to a specific port in the same country and on occasions to a port in another country. He would be requested to obtain a full set of bladings from the steamship company and could be authorized to forward them directly to the importer, the custom house broker or return them to the beneficiary, who would forward them himself to the buyer. Often the importer names a foreign forwarding agent in the credit whom he employs, who will follow the shipping instructions received from him and dispose of the bladings as he directs. Under such an arrangement, control of the shipment rests entirely with the forwarding agent, who must necessarily have a good reputation in the trade. The issuing bank would not be agreeable to the substitution of a forwarding agent's receipt for bills of lading in the terms of the credit *unless* the financial condition of the importer warranted unsecured credit or if the forwarding agent would agree to send the relative bladings to the bank directly, so that it would control the shipment in the event the letter of credit was issued on a secured basis.

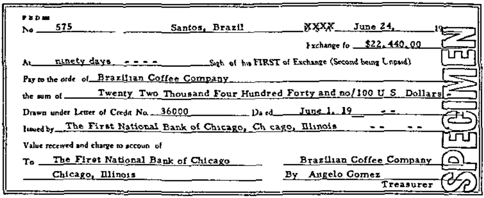
Other steps prior to negotiation. The draft, (Figure 121), in this case at ninety days sight, is drawn by the beneficiary on the issuing bank, The First National Bank of Chicago, in the amount of $22,440.00. The commercial invoice is billed to the importer showing 500 bags of coffee at 34 cents per pound C and F New Orleans, Louisiana and also must show the same dollar amount as the draft—no more, no less. A customs invoice, a form provided by the United States Government, must be completed with the required information by the beneficiary, presented to the United States Embassy nearest him and consularized by the proper consular officer. These steps having been accomplished, the draft is ready to be negotiated.

First Negotiating Bank

The beneficiary presents the draft, together with the required documents called for in the credit and also the original letter of credit to his

local bank, which, in the terminology of the credit, is to become the first negotiating bank Much responsibility is assumed by this bank, as it must make certain that all of the conditions of the credit have been fulfilled by the beneficiary The local bank is quite willing to assume the risks involved in negotiating the draft on the strength of the issuing bank's assurance that drafts drawn in accordance with terms of the credit will be honored

Figure 121 Draft Form Signed by Beneficiary of Commercial Letter of Credit



FROM

No 575 Santos, Brazil XXXX June 24, 19

Exchange fo $22,440.00

At ninety days - - - - Sight of his FIRST of Exchange (Second being Unpaid)

Pay to the order of Brazilian Coffee Company

the sum of Twenty Two Thousand Four Hundred Forty and no/100 U S Dollars -

Drawn under Letter of Credit No. 36000 Dated June 1, 19 - -

Issued by The First National Bank of Chicago, Chicago, Illinois - - - -

Value received and charge to account of

To The First National Bank of Chicago
Chicago, Illinois

Brazilian Coffee Company
By Angelo Gomez
Treasurer

Purchase of 90 day dollar bills of exchange What the negotiating bank actually does, if the beneficiary desires immediate reimbursement, is to purchase the draft at the current rate of exchange for 90 day dollar bills of exchange, a lower rate than the spot rate for demand drafts This difference reflects the interest charge for the airmail transit time from Brazil to Chicago and return, approximately ten days, in addition to the 90 day tenor of the draft In other words, the foreign exchange trader in the local bank knows that he will not receive reimbursement for approximately 100 days from the time he purchases the bill of exchange from the beneficiary The lower rate also allows for a profit on the conversion from dollars to cruzeiros, in which currency the beneficiary will be paid, and also represents consideration to the bank for the risk taken

Endorsement of draft amount on letter of credit Before making final payment, the negotiating bank, for its own protection, must make certain the beneficiary has complied with all of the conditions of the letter of credit The draft must bear on its face the number of the letter of credit The bank must also endorse the date of the negotiation, the amount paid and show itself as the payer on the reverse side of the letter of credit

Disposition of draft and documents by negotiating bank. The Brazilian bank follows the instructions in the credit and attaches to the draft one commercial invoice and one bill of lading out of three, assuming that the steamship company had issued a full set of three originals. The bank also attaches to the draft its certificate stating that the remaining documents have been dispatched to the Louisiana Forwarding Company of New Orleans, Louisiana. The draft and documents mentioned are then forwarded directly or through its American bank correspondent by the negotiating bank to The First National Bank of Chicago for acceptance.

Function of Custom House Broker

When the Louisiana Forwarding Company of New Orleans receives the "remaining documents" from the first negotiating bank, it takes delivery of the shipment from the steamship company when the steamer arrives by surrendering one of the original bills of lading. It clears the coffee through customs by submitting the customs invoice to the custom house at New Orleans. After the shipment has been released by the customs officials, the broker then follows the instructions of the importer as to further disposition of the shipment.

Disposition of shipment. The entire lot of 500 bags may be forwarded directly to Chicago or it may be split into several smaller shipments and forwarded directly to the eventual end users specified by the importer. This, of course, saves handling and transportation expenses which would be incurred if the entire shipment were forwarded to Chicago and then diverted to the ultimate destinations.

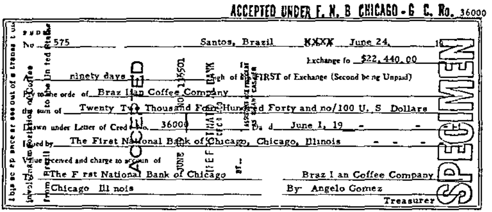
Shipments "in bond" to inland points. If the importer decides that the entire shipment of coffee will be sold in the Chicago area, he will instruct the custom house broker at the port of New Orleans to ship 500 bags of coffee "in bond" to Chicago instead of effecting a "consumption entry" at New Orleans. While the goods are "in bond," they are under control of the Federal government until they are cleared through customs at Chicago.

Procedures followed by the Accepting Bank

When the draft and the accompanying documents reach the office of the bank which originally issued the letter of credit, the bank ascertains whether all terms of the credit have been followed. It notes from the certificate received from the first negotiating bank that the required

documents have been forwarded to the custom house broker at the port of New Orleans Further, it must account for the full set of bills of lading issued by the steamship company When the bank has satisfied itself that everything is in order, it directs its attention to the time draft drawn by the beneficiary under its commercial Letter of Credit G C 36000 (Figure 121) If the draft is drawn properly, the bank places its acceptance stamp on the face of the draft, at which time a bankers' acceptance is created (Figure 122) The commercial invoice and bill of lading which were attached to the time draft are turned over to the customer against

Figure 122 Bankers' Acceptance Created by Issuing Bank from Time Draft Drawn by Beneficiary


ACCEPTED UNDER F. N. B CHICAGO - G C. No. 36000

No 575 Santos, Brazil June 24, 19

Exchange fo $22,440.00

At ninety days sight of this FIRST of Exchange (Second being Unpaid)

Pay to the order of Brazilian Coffee Company

the sum of Twenty Two Thousand Four Hundred Forty and no/100 U. S Dollars

Drawn under Letter of Credit No. 36000 Dated June 1, 19

Issued by The First National Bank of Chicago, Chicago, Illinois

Value received and charge to account of

To The First National Bank of Chicago, Chicago Illinois

Brazilian Coffee Company

By Angelo Gomez

Treasurer

ACCEPTED JUNE THE FIRST NATIONAL BANK

SPECIMEN

a trust receipt (Figure 123), which is part of fanfold form of the advice to the importer that the bank has accepted a time draft (Figure 124)

Sight draft transaction When a letter of credit has been issued providing for the beneficiary to draw a draft on the issuing bank *at sight*, the exporter adopts the same procedure followed in a time draft transaction in procuring the bills of lading and preparing his documents for presentation to the first negotiating bank which discounts his dollar bill of exchange and proceeds to dispose of the documents in accordance with the terms of the credit When the sight draft is presented to the issuing bank, it pays the draft immediately if the conditions of the credit are complied with, charges the account of the importer and turns the documents over to him against a plain receipt (Figure 125), which is a part of the fanfold advice form (Figure 126) sent to the customer

Instructions received from negotiating bank by accepting bank The negotiating bank is aware that the 90 day sight draft which it negotiated

under the issuing bank's Letter of Credit number 36000 will not be due for payment until 90 days after the acceptance date. It has to decide whether to request the accepting bank to discount the acceptance and

Figure 123 Trust Receipt Used When Documents Are Released Prior to Payment of Acceptance

F B D 83

PLEASE RETURN PROMPTLY TO
The First National Bank of Chicago
CHICAGO 90, ILLINOIS
INTERNATIONAL BANKING DEPARTMENT

Date June 29,

FROM American Importing Company

Chicago, Illinois

UNDER CREDIT OPENED June 1,

IN FAVOR OF Brazilian Coffee Company, Santos

RECEIVED IN TRUST FROM THE FIRST NATIONAL BANK OF CHICAGO DOCUMENTS UNDER THE ABOVE CREDIT AS DESCRIBED BELOW

CREDIT NO	TENOR	DUE DATE	AMOUNT	COMMISSION		TOTAL
				RATE	AMOUNT	
G.C. 36000	90 D/S	9/27/-	$22,440.00	3/8%	$84.15	$22,524.15

DOCUMENTS

ORIGINAL RECEIVED	DUPLICATE TO FOLLOW	
1/3		OCEAN ~~XXXXXXX~~ BILL OF LADING
1		INVOICES
		CONSULAR INVOICE
		INSURANCE CERTIFICATE

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COVERING SHIPMENT OF 500 bags of coffee

PER S S Del Norte

WE HEREBY UNDERTAKE TO HOLD THE SAID PROPERTY ON ACCOUNT OF SAID BANK AND SUBJECT TO ITS ORDER FOR THE PURPOSE OF BEING SOLD OR OTHERWISE DEALT WITH AS THE SAID BANK MAY DIRECT AND WHEN SOLD TO PAY IN THE NET PROCEEDS TO SAID BANK. WE HEREBY ACKNOWLEDGE OURSELVES TO BE TRUSTEES OF SAID PROPERTY FOR SAID BANK. WE FURTHER AGREE THAT THE SECURITY INTEREST (AS DEFINED IN THE UNIFORM TRUST RECEIPTS ACT OF THE STATE OF ILLINOIS) IN THE GOODS DOCUMENTS AND INSTRUMENTS DESCRIBED HEREIN REMAINS IN THE SAID BANK FOR ITSELF OR FOR ANY ONE FOR WHOM IT IS ACTING AS AGENT

TRUST RECEIPT

PLEASE PROMPTLY CHECK THE ATTACHED DOCUMENTS AND IF FOUND IN ORDER, AFFIX YOUR OFFICIAL SIGNATURE HERETO AND RETURN TO US.

American Importing Company
By: John Smith, Treasurer
OFFICIAL SIGNATURE

credit its account or to hold it until the maturity date, at which time its account will be credited.

In the event that the negotiating bank wishes immediate credit, it will authorize the accepting bank to discount the acceptance at the prime

bankers acceptance discount rate for 90 day bills The policy of American banks varies in the procedure followed Some banks discount the acceptances and hold them in their own portfolio until maturity, thus deriving the interest which accrues during the 90 day period at the dis

Figure 124 Advice to the Importer under a Commercial Letter of Credit that the Bank Has Accepted a Time Draft

FED 30

The First National Bank of Chicago
CHICAGO 90 ILLINOIS
INTERNATIONAL BANKING DEPARTMENT

Date June 29,

American Importing Company
Chicago, Illinois

THE FOLLOWING DRAFT HAS BEEN ACCEPTED UNDER CREDIT OPENED June 1,
IN FAVOR OF Brazilian Coffee Company, Santos

AGAINST THE ENCLOSED DOCUMENTS DESCRIBED BELOW AT MATURITY WE WILL CHARGE YOUR ACCOUNT / PLEASE SEND US YOUR CHECK FOR THE AMOUNT OF THIS ACCEPTANCE, PLUS OUR COMMISSION CHARGE SHOWN BELOW PLEASE SIGN AND RETURN THE ATTACHED TRUST RECEIPT

CREDIT NO.	TENOR	DUE DATE	AMOUNT	COMMISSION %	COMMISSION AMOUNT	TOTAL
G C 36000	90 D/S	9/27/-	$22 440 00	3/8%	$84 15	$22 524 15

DOCUMENTS

[illegible]	[illegible] TO FOLLOW	
1/3		OCEAN BILL OF LADING
1		INVOICES
		CONSULAR INVOICE
		INSURANCE CERTIFICATE

SPECIMEN

COVERING SHIPMENT OF 500 bags of coffee
PER S S Del Norte

count rate, which varies from month to month and year to year Other banks sell the acceptances immediately to acceptance discount houses which maintain a ready market offering quotations either to buy or sell prime bankers acceptances After discounting the acceptance, the proceeds are either credited to the negotiating bank's account or disposed of in accordance with its instructions At the maturity date of the accept-

ance, the holder presents it to the accepting bank for payment and the bank in turn receives reimbursement from its customer by charging his account or receiving payment in the form of his check.

Figure 125 Plain Receipt Signed by a Purchaser Acknowledging Receipt of Documents on a Sight Draft Transaction

FBO 347

FROM

PLEASE SIGN AND RETURN THIS RECEIPT TO
The First National Bank of Chicago
INTERNATIONAL BANKING DEPARTMENT
CHICAGO 90 ILLINOIS

American Importing Company
Chicago, Illinois

ACCT NO DIV DATE June 29, ____

PAYMENT HAS BEEN MADE AGAINST LETTER OF CREDIT NO G. C. 36000
ISSUED IN FAVOR OF Brazilian Coffee Company,
SHIPMENT OF 500 bags of coffee Santos
PER S S Del Norte

[x] CHARGE OUR ACCOUNT
[ ] ATTACHED IS OUR CHECK

Twenty-Two Thousand Four Hundred Sixty-Eight and 5/100 - - - DOLLARS $ 22,468.05

REMARKS

SPECIMEN

ORIGINAL	DUPLICATE		ORIGINAL	DUPLICATE	
1/3		OCEAN (ON BOARD) BILL OF LADING XXXXXX			
1		INVOICES			
		CUSTOM INVOICE			
		INSURANCE CTF			

AMOUNT OF DRAFT	$22,440	00
COMMISSION 1/8 %	28	05
INTEREST DAYS @ %		
FOREIGN BANK CHARGES		
TOTAL $	$22,468	05

PLEASE PROMPTLY CHECK THE ATTACHED DOCUMENTS AND IF FOUND IN ORDER, AFFIX YOUR OFFICIAL SIGNATURE HERETO AND RETURN TO US.

RECEIPT ________________ OFFICIAL SIGNATURE

EXPORT LETTERS OF CREDIT

Export credits may be confirmed or unconfirmed, irrevocable or revocable, revolving or straight, cumulative or non-cumulative, or assignable and divisible.

It has been mentioned that a letter of credit financing an importation of merchandise for a customer becomes an export letter of credit in the hands of the foreign seller, or beneficiary. A summary of the procedure followed by the seller in negotiating against the credit was given. Let us

briefly scrutinize the transaction in reverse, in other words, where we view the foreign importer's letter of credit as an export letter of credit in the hands of an American seller, or beneficiary

The foreign importer has requested his bank to issue a letter of credit in favor of an American exporter who may have requested that the credit be

Figure 126 Advice to the Importer that the Bank Has Paid a Sight Draft under a Commercial Letter of Credit

FBO 347

The First National Bank of Chicago
INTERNATIONAL BANKING DEPARTMENT
CHICAGO 90 ILLINOIS

American Importing Company ACCT NO IN DATE June 29,
Chicago, Illinois

PAYMENT HAS BEEN MADE AGAINST LETTER OF CREDIT NO G C 36000
ISSUED IN FAVOR OF Brazilian Coffee Company, Santos
SHIPMENT OF 500 bags of coffee
PER S S Del Norte

[x] WE HAVE CHARGED YOUR ACCOUNT

[ ] PLEASE SEND US YOUR CHECK

Twenty Two Thousand Four Hundred Sixty Eight and 5/100 - - - - DOLLARS $ 22,468 05

BY

REMARKS

SPECIMEN

ORIGINAL	DUPLICATE		ORIGINAL	DUPLICATE				
1/3		OCEAN ON BOARD BILL OF LADING				AMOUNT OF DRAFT	$22,440	00
1		INVOICES				COMMISSION 1/8 %	28	05
		CUSTOM INVOICE				INTEREST DAYS @ %		
		INSURANCE CTF				FOREIGN BANK CHARGES		
						TOTAL $	$22,468	05

advised through his bank Upon receipt of the foreign bank's advice, giving all details of the credit, the American bank in turn conveys the terms of the credit to the beneficiary, the American seller

Confirmed credits The situation frequently arises in which the beneficiary does not wish to accept a letter of credit issued by a foreign bank and requests the confirmation of the foreign bank's letter of credit by an American bank The amount of letters of credit which an American bank will confirm for a foreign *correspondent bank is usually* governed by a line of credit extended ordinarily for a period of a year The credit line is based on the credit worthiness of the issuing bank which is

determined from credit information received from other American and foreign banks, as well as the experience which the confirming bank has enjoyed or suffered in its relations with the issuing bank in past years. If the American bank is satisfied with the credit standing and reputation of the foreign issuing bank, it will add its confirmation and advise the terms of the credit to the beneficiary in its confirmed letter of credit form (Figure 127). The seller then looks for payment only to the American bank; however, he also has recourse to the foreign issuing bank if the confirming bank becomes bankrupt. The American bank exacts a confirmation charge from the foreign bank, as well as a negotiation charge. These charges are in turn passed on to the foreign importer by inclusion in the commission charge assessed by the foreign bank for issuing a sight or time letter of credit.

Unconfirmed credits. The foreign bank may issue its letter of credit and forward it directly to the beneficiary, or it may give the credit to the importer who will send it to the seller. Delivery may also be effected through the medium of an American bank by mail or cable. When this happens, the advising bank transcribes the details in a letter of advice (Figure 128). This is termed an unconfirmed letter of credit and conveys no engagement on the part of the advising bank to negotiate and pay the beneficiary's documentary draft at a later date. As indicated in the second paragraph, the letter is *solely an advice* of a credit issued by its correspondent. Should the advising bank negotiate and pay the beneficiary when proper documents and a draft are presented, payment is final and the bank has no recourse to the beneficiary. At the time of negotiation, the original letter of advice must be submitted to the bank along with the draft and documents. If the negotiation is against documents representing a partial shipment and a balance still remains in the credit, the American bank would endorse the amount of the payment on the reverse side of the advice and return it to the beneficiary. The first negotiation does not establish a precedent by the American bank as it may refuse to negotiate another documentary draft presented by the beneficiary at a later date under the same credit which it has not confirmed.

Irrevocable and Revocable Credits. The majority of export credits issued in favor of American exporters are irrevocable, as the exporter would not care to assume the risk of having the credit cancelled if it were in revocable form. The same rules apply, however, on a revocable credit in that drafts negotiated by an American bank prior to receipt of a notice of cancellation of a credit by the issuing foreign bank would obligate the foreign bank to reimburse the American bank for the payment made.

Figure 127 Form of Original Credit (*used by The First National Bank of Chicago in notifying an American exporter of the terms of an irrevocable confirmed letter of credit opened in his favor*)

No CE 13260 US$10,000.00

THE FIRST NATIONAL BANK OF CHICAGO

CHICAGO 90 ILLINOIS

American Exporting Company April 7, ----
Chicago
Illinois

SPECIMEN

GENTLEMEN

WE HAVE RECEIVED A letter DATED April 2, ---- FROM
Banco Boavista S A Rio de Janeiro, Brazil
INFORMING US THAT they
HAVE ISSUED THEIR irrevocable CREDIT NO 6020 IN YOUR FAVOR
FOR Ten Thousand and 00/100 United States Dollars - ----------------------
FOR ACCOUNT OF Brazilian Importing Company, Rio de Janeiro, Brazil
AVAILABLE UPON PRESENTATION OF THE FOLLOWING DOCUMENTS AT OUR OFFICE ON OR BEFORE
June 30, ---- ----- --- ---------------------------------------
DRAFTS SHOULD INDICATE THAT THEY ARE DRAWN UNDER The First National Bank of Chicago, Chicago, Illinois - reference No CE 13260 - - ---- --- -------------------

1 Drafts at sight in duplicate drawn on The First National Bank of Chicago, Chicago Illinois
2 Five commercial invoices 1st, 2nd and 5th visaed by the Brazilian Consul, indicating the FOB value, the cost of freight and insurance
3 Certificate of origin in triplicate visaed by the Brazilian Consul
4 Insurance Policy or Certificate in duplicate covering marine risks up to Rio de Janeiro to order and blank indorsed
5 Full set of CLEAN NEGOTIABLE ON BOARD OCEAN bills of lading to order blank indorsed, marked freight prepaid

COVERING SHIPMENT OF 1 Tractor Model BD 600, shipped from any USA Port to Rio de Janeiro C I F
Partial shipments are prohibited
Transshipments are prohibited
Import Certificate No 14-50/823 must appear on all documents

EXCEPT SO FAR AS OTHERWISE EXPRESSLY STATED, THIS CREDIT IS SUBJECT TO THE UNIFORM CUSTOMS AND PRACTICE FOR COMMERCIAL DOCUMENTARY CREDITS FIXED BY THE THIRTEENTH CONGRESS OF THE INTERNATIONAL CHAMBER OF COMMERCE. FOR THE DEFINITIONS OF CERTAIN EXPORT QUOTATIONS REFERENCE IS MADE TO THE GENERAL DESCRIPTIONS OF THOSE TERMS INCLUDED IN THE REVISED AMERICAN FOREIGN TRADE DEFINITIONS 194

IF THE TERMS OF THE CREDIT DO NOT MEET YOUR REQUIREMENTS, PLEASE COMMUNICATE AT ONCE EITHER WITH YOUR PRINCIPALS OR WITH US IN ORDER TO HAVE THE CREDIT APPROPRIATELY AMENDED BY THE ISSUING BANK.

THIS LETTER OF ADVICE MUST ACCOMPANY YOUR DRAFTS WHEN PRESENTED FOR NEGOTIATION.

WE CONFIRM THE CREDIT AND THEREBY UNDERTAKE THAT ALL DRAFTS DRAWN AND PRESENTED AS ABOVE SPECIFIED WILL BE DULY HONORED BY US.

WHEN CREDITS HAVE BEEN ADVISED TO US BY CABLE PARTICULARS THEREOF ARE SUBJECT TO CONFIRMATION BY MAIL.

YOURS VERY TRULY

Figure 128 Letter of Advice *(used by The First National Bank of Chicago in notifying an American exporter that an unconfirmed irrevocable letter of credit has been opend in his favor)*

FBD 387

No. E 9631 US$10,000.00

The First National Bank of Chicago

CHICAGO 90 ILLINOIS

INTERNATIONAL BANKING DEPARTMENT

American Exporting Company
Chicago
Illinois

DATE April 7, ----

GENTLEMEN

WE HAVE RECEIVED A letter DATED April 2, ---- FROM Banco Boavista S.A., Rio de Janeiro, Brazil INFORMING US THAT they HAVE ISSUED THEIR irrevocable CREDIT NO 6020 IN YOUR FAVOR FOR Ten Thousand and 00/100 United States Dollars ------------------------ FOR ACCOUNT OF Brazilian Importing Company, Rio de Janeiro, Brazil AVAILABLE UPON PRESENTATION OF THE FOLLOWING DOCUMENTS AT OUR OFFICE ON OR BEFORE June 30, ---- -- DRAFTS SHOULD INDICATE THAT THEY ARE DRAWN UNDER: The First National Bank of Chicago, Chicago, Illinois - reference No. E 9631 -----------------------------------

1. Drafts at sight in duplicate drawn on The First National Bank of Chicago, Chicago, Illinois.
2. Five commercial invoices, 1st, 2nd and 5th visaed by the Brazilian Consul, indicating the FOB value, the cost of freight and insurance.
3. Certificate of origin in triplicate visaed by the Brazilian Consul.
4. Insurance Policy or Certificate in duplicate covering marine risks up to Rio de Janeiro, to order and blank indorsed.
5. Full set of CLEAN NEGOTIABLE ON BOARD OCEAN bills of lading to order blank indorsed, marked freight prepaid.

COVERING SHIPMENT OF. 1 Tractor Model BD 600, shipped from any USA Port to Rio de Janeiro C.I.F.

Partial shipments are prohibited.

Transshipments are prohibited.

Import Certificate No. 14-50/823 must appear on all documents.

THIS LETTER IS SOLELY AN ADVICE OF A CREDIT ISSUED BY OUR CORRESPONDENT AND CONVEYS NO ENGAGEMENT BY US IF THE TERMS OF THE CREDIT DO NOT MEET YOUR REQUIREMENTS PLEASE COMMUNICATE AT ONCE EITHER WITH YOUR PRINCIPALS OR WITH US IN ORDER TO HAVE THE CREDIT APPROPRIATELY AMENDED BY THE ISSUING BANK

WHEN CREDITS HAVE BEEN ADVISED TO US BY CABLE, PARTICULARS THEREOF ARE SUBJECT TO CONFIRMATION BY MAIL.

EXCEPT SO FAR AS OTHERWISE EXPRESSLY STATED, THIS CREDIT IS SUBJECT TO THE UNIFORM CUSTOMS AND PRACTICE FOR COMMERCIAL DOCUMENTARY CREDITS FIXED BY THE THIRTEENTH CONGRESS OF THE INTERNATIONAL CHAMBER OF COMMERCE FOR THE DEFINITIONS OF CERTAIN EXPORT QUOTATIONS REFERENCE IS MADE TO THE GENERAL DESCRIPTIONS OF THOSE TERMS INCLUDED IN THE "REVISED AMERICAN FOREIGN TRADE DEFINITIONS, 1941".

THIS LETTER OF ADVICE MUST ACCOMPANY YOUR DRAFTS WHEN PRESENTED FOR NEGOTIATION.

YOURS VERY TRULY,

SPECIMEN

PER PRO VICE PRESIDENT

Although an irrevocable credit may not be cancelled without the conser of both buyer and seller, no assurance is given the beneficiary by the ad vising American bank that it will honor his drafts

Discrepancies in documents Where letters of credit are advise through a bank, in most cases it is called upon by the beneficiary to nego tiate the draft and documents against the advice it has issued Frequently drafts and documents are not drawn in accordance with the terms of th letter of credit If the discrepancies can be remedied by the drawer, he asked to do so However, if the discrepancies cannot be rectified, th negotiating American bank can cable, at the drawer's expense, to the issu ing bank for authorization to negotiate the documents against the cred despite the discrepancies, or, if the beneficiary is an account of the nego tiating bank and his credit standing is unquestioned, the bank will usuall take his written agreement to hold it harmless for paying the draft despi the discrepancies If the documents are in order, the negotiation is mac and the amount of the draft endorsed on the reverse side of the letter c advice A cashier's check is given to the beneficiary for the amount of h draft or a credit is placed to his account The negotiating bank reimburs itself by charging the account of the bank issuing the letter of credit no account relationship exists, instructions are usually contained in th credit to effect reimbursement through another American bank In th case of a confirmed letter of credit, reimbursement is ordinarily obtaine by charging the amount of the draft to the issuing bank's account

AUTHORITY TO PURCHASE

This credit instrument is similar to a letter of credit except that th authority to purchase specifies that the exporter's draft should be draw on the buyer instead of a bank This method of financing foreign trac originated in the Orient, where importers often encountered difficulty : obtaining bank credit to finance the importation of merchandise Aft the Oriental importer had agreed with an American exporter on th terms of the purchase-sales contract, the exporter was authorized by th Oriental to draw drafts upon him The importer then requested his loc bank to authorize its American correspondent bank to purchase draf drawn by the American exporter on the Oriental importer within spec fied limits

Authorities to purchase are comparatively little used except in expo transactions with the Far East They are generally revocable, and th drafts provide for full recourse on the drawer Occasionally, a Far Eas

ern bank will issue an instrument called a "confirmed irrevocable authority to purchase," which is much the same as a confirmed and irrevocable commercial letter of credit. The essential difference is that the drafts are drawn generally without recourse and are usually drawn on the buyer instead of on his bank.

UNIFORM CUSTOMS AND PRACTICE

Banks in the United States have protected themselves to some extent through adherence to Uniform Customs and Practice for Commercial Documentary Credits fixed by the Thirteenth Congress of the International Chamber of Commerce held at Lisbon, Portugal in June 1951. The general provisions, definitions, interpretation of terms and guiding provisions govern negotiations made by banks in the United States, which fact is common knowledge to the majority of the foreign banks issuing letters of credit in favor of beneficiaries located in this country. As of November 1, 1959, banks in the United States, the principal countries in Europe, Latin America, the Near East and the Caribbean area, about fifty-eight countries in all, had acknowledged their adherence to the "1951 Uniform Customs." English and British Commonwealth banks are not included as adherents, although the difference between English practice and that found in the 1951 Uniform Customs is not great. Credits confirmed and advised to American beneficiaries by American banks for foreign issuing banks usually contain the following paragraph:

"Except so far as otherwise expressly stated, this credit is subject to the Uniform Customs and Practice for Commercial Documentary Credits fixed by the Thirteenth Congress of the International Chamber of Commerce; for the definitions of certain export quotations reference is made to the general description of those terms included in the 'Revised American Foreign Trade Definitions, 1941.'"

Summary of Legal Decisions on Commercial Letters of Credit[1]

From a review of decisions on commercial letters of credit, the following principles may be deducted:

1. A letter of credit is not a negotiable instrument.
2. It does not create a trust fund in favor of the beneficiary.
3. An issuer of a letter of credit may not dishonor drafts presented by

[1] *Encyclopedia of Banking and Finance*, Bankers Publishing Co., Cambridge, Mass. 1949.

a negotiating bank under a clean irrevocable letter of credit if all terms of the letter of credit are fulfilled

4 An issuer may dishonor bills drawn in violation of the conditions specified in a documentary letter of credit

5 The negotiator is not liable for the genuineness either of goods or documents

6 The issuer is responsible to the party requesting the credit for the observance of the conditions by the beneficiary

7 The contract between the issuer and the beneficiary is entirely independent of the contract of sale between the buyer and seller, and the issuer cannot, because of the seller's breach of contract of sale, refuse to honor drafts which comply with the terms of the letter of credit

FINANCING UNDER BANKERS ACCEPTANCES

A banker's acceptance is created by a commercial bank or trust company which accepts a time draft drawn on it by

1 The beneficiary of its commercial letter of credit

2 Its customer who wishes to finance merchandise or commodities in warehouse against negotiable warehouse receipts

Since bankers' acceptances created under commercial letters of credit have been described previously, the following discussion will be confined to the second type mentioned above

The institution which accepts the time draft is primarily liable and the drawer is secondarily liable The acceptor indicates its acceptance usually by means of a stamp which imprints the word "Accepted," the date of acceptance and its name on the face of the draft The acceptance is officially signed manually by an authorized signer and it may also indicate the name of an alternate payer besides the drawee who will honor it at maturity After acceptance, the time draft is accorded the same status in law as a promissory note The acceptor becomes the maker and the drawer becomes the indorser

Distinction between Bankers' and Trade Acceptances The fundamental distinction between a banker's acceptance and a trade acceptance is that the acceptor of the former is a bank or trust company and the acceptor of the latter is the buyer of merchandise Since the credit position of a bank generally is more widely and favorably known than that of the average purchaser of merchandise, a banker's acceptance enjoys a broader market and a more favorable rate of interest than a trade acceptance

Prime Bankers' Acceptances. This is a rather nebulous term to define. Any bank or trust company which accepts a time draft creates a banker's acceptance. Well known discount houses dealing primarily in the purchase and sale of bankers' acceptances create the market by publishing bid and offered quotations for prime bankers' acceptances. These houses determine which bankers' acceptances are prime; in other words, those which are readily marketable and in demand by investors. Banks, investment bankers, insurance companies and customers of banks located in foreign countries are interested in buying American bankers' acceptances; however, these investors prefer acceptances created by banks well known not only in the United States but also internationally. Therefore, a prime bank may be considered as one of a limited number of banks whose reputation as an international bank has become established through the recognition and acceptance of its commercial letters of credit not only by banks alone but also by exporters in the major trading centers of the world.

Bankers' Acceptances in Domestic Trade

Bankers' acceptances are used rather widely in financing merchandise and commodities stored in warehouses. Certain types of non-perishable merchandise, such as automobiles, pianos and furniture, and commodities, such as cotton, grain, coffee, sugar, and eggs and meat in cold storage, are examples.

Cotton, one of the most important agricultural products of the United States, is a commodity most frequently financed in a warehouse. To illustrate the use of bankers' acceptances in domestic trade, we shall assume that a cotton broker wishes to borrow money on cotton stored in a warehouse in order to recover sufficient working capital which had been used to purchase a large volume of cotton in bales. The cotton broker draws a draft on the bank for the amount desired and for the period for which he wishes the funds.

In the illustrated case, the Southern Cotton Company of Memphis, Tennessee, draws five drafts for $100,000 each, in the aggregate principal amount of $500,000, on The First National Bank of Chicago, at 90 days' sight. It is previously agreed that drafts in amounts of $100,000 each will be drawn, because in those denominations bankers' acceptances are more easily disposed of than in denominations of $500,000. The draft is accepted by the bank to mature on August 30, and inasmuch as the cotton company wishes the funds immediately, it instructs the bank to discount

the draft at the prime bankers' acceptance rate for 90 day drafts The cotton company pays the bank an acceptance commission at the rate of 1½% per annum Some banks require payment of the acceptance commission on the date of acceptance and others on the date of maturity of the acceptance The proceeds of the discounted acceptance are credited to the account of the cotton company

Policies of banks differ in the disposition of the discounted acceptance Some hold it in their portfolio and others sell the instrument in the open market There is a steady demand for prime bankers' acceptances on the part of investors having excess funds available for short term investment purposes

Acceptance and Pledge Agreement The cotton company signs an agreement (Figure 129) which describes the nature of the collateral covered by the warehouse receipts pledged to secure the acceptance

In the illustration used, the cotton is stored in Memphis, Tennessee, the domicile of the borrower, whereas the lending bank is located in Chicago Inasmuch as the cotton company is continually selling cotton to various end users, it often happens that they require certain bales which are covered by warehouse receipts against which the Chicago bank has made the loan. As a matter of convenience, the warehouse receipts are deposited and held by The First National Bank of Memphis, Tennessee, as custodian for the account of The First National Bank of Chicago When certain bales held as collateral to the lending bank's loan are required by the borrower, an equal number of warehouse receipts covering other bales are brought to the custodian and substituted for the receipts covering the cotton which has been sold so that at all times the custodian has under its control receipts covering 3,300 bales of raw cotton

Eligibility Clause To abide by the regulations of the Federal Reserve Bank and in order that the discounted acceptance may be sold in the open market, a phrase is stamped on the acceptance, reading as follows "At the time of acceptance, this draft was secured by warehouse receipts covering cotton stored in the U S A and/or bills of lading covering cotton in transit" This phrase describes the underlying transaction being financed and makes the acceptance eligible for rediscount at a Federal Reserve Bank

Advantages of Bankers' Acceptances

1 The bank may decide that its own acceptance is a prime investment and hold it in its own portfolio

Figure 129 Acceptance and Pledge Agreement (*signed by drawer to support borrowings against warehouse receipts*)

ACCEPTANCE AND PLEDGE AGREEMENT

June 1, 19___

The First National Bank of Chicago
Chicago 90, Illinois

Gentlemen:

In consideration of the acceptance by you of the undersigned's drafts drawn on you today, Numbered 101 to 105, inclusive, in the aggregate principal amount of $500,000.00 and payable on August 30, 19 , the undersigned hereby agrees to pay you at your banking house in Chicago the aforesaid principal amount in lawful money of the United States on the date of maturity of such drafts, plus a commission thereon at the rate of 1-1/2% per annum payable on the date of acceptance.

As security for the payment of the foregoing obligation and all other obligations of the undersigned to you, howsoever arising, whether now existing or hereafter created, direct or indirect, the undersigned does, by these presents, transfer, assign and set over to you the following:

Southern Gulf Warehouse Co., Memphis, Tennessee Warehouse Receipts covering a total of 3,300 Bales Raw Cotton to be held by The First National Bank of Memphis, Tennessee, as custodian, for your account.

The undersigned agrees to insure fully with responsible insurance companies all goods and materials represented by the foregoing documents. Such insurance will contain appropriate loss payable provisions in your favor.

Upon any default by the undersigned on any of its obligations to you, or upon the insolvency of the undersigned, howsoever evidenced, all indebtedness of the undersigned to you shall, upon demand, become immediately due and payable. Upon any such default you may sell all or any part of the property of the undersigned held by you as security, including but not limited to the property described above, at any Broker's Board, or at public or private sale, without notice, advertisement or demand of any kind, all of which are hereby expressly waived. At any sale you may purchase the whole or any part of the property sold. After any such sale you may apply the net proceeds thereof first to the payment of all expenses of such sale, next to the payment of all obligations of the undersigned to you, returning the remainder, if any, to the undersigned upon demand. The undersigned shall remain liable for any deficiency in the payment of such obligations.

Further, upon any such default by the undersigned or upon any such insolvency of the undersigned, any sums owing by you to the undersigned may be appropriated and applied at any time on any obligation of the undersigned to you.

This Agreement shall be binding upon and shall inure to the benefit of the successors and assigns of the undersigned and your bank. All rights hereunder shall be determined in accordance with the laws of the State of Illinois.

Southern Cotton Company, Memphis, Tennessee

By John A. Brown
Treasurer

2 Occasionally customers may borrow at somewhat lower rates by using the bank acceptance At times, the prime bankers' acceptance discount rate, plus the acceptance commission, is somewhat less than the customer's borrowing rate on secured loans Since the banker's acceptance discount rate fluctuates from time to time, on frequent occasions it has been disadvantageous to the borrower because the cost of financing in this manner would exceed the cost of straight loans

3 The credit standing and the reputation of the accepting bank determine whether the paper on which its acceptance appears is prime Investors are able to determine readily the merit of the acceptance by considering the goodness, responsibility and credit worthiness of the accepting bank

4 Banks may supplement their income by accepting drafts of desirable customers and receive a commission for the acceptance Their income may be further enhanced by discounting their own acceptances

5 Prime bankers' acceptances are easily marketable, as they are obligations of well known banking institutions

Bankers' Acceptances in Foreign Trade

An exporter of merchandise may also finance his business transactions by bankers' acceptances created by means other than a letter of credit For instance, when an exporter ships merchandise abroad, he may draw a draft, with the documents attached, on the foreign importer The bank may take the draft and the documents, and then proceed to collect the amount due to the exporter, a process which may require a number of weeks, if the goods are moving a long distance

To obtain his funds promptly, the exporter at the same time may enter into an agreement with his bank, under which he draws a time draft upon the bank for the same amount. Across the draft the bank writes its acceptance The bank also places the following notation on the face of the draft "The transaction which gives rise to this instrument is the exportation of ____________ from ____________ to ____________." The acceptance is discounted by the bank and the proceeds are given to the exporter The draft is made to mature at about the time that payment is anticipated in this country on the draft sent abroad with the documents for collection The bank expects the borrower to liquidate the acceptance

through the proceeds of that collection. If these proceeds are not sufficient or are not received, the bank looks directly to the drawer for payment.

COLLECTING AND DISCOUNTING DRAFTS

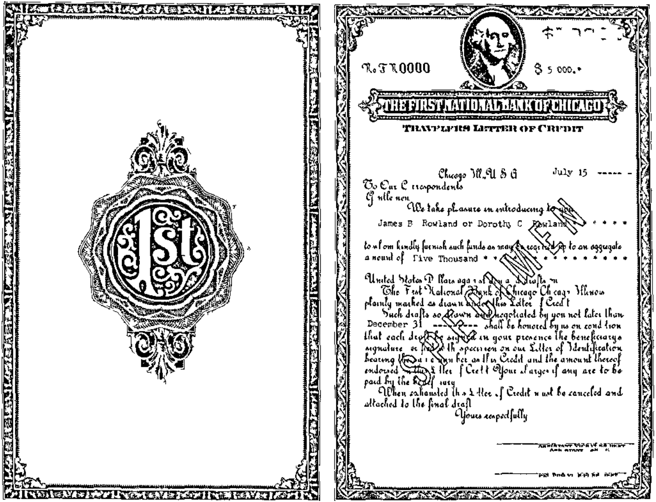
In connection with both foreign and domestic business transactions, a seller often draws a draft upon a buyer. The documents conveying title to the merchandise are attached to the draft, which may then be presented to a bank for collection. The bank forwards the draft and the attached documents to a bank in the community where the buyer lives. The latter bank receives payment for the draft from the buyer and remits to the seller's bank, which in turn credits the seller's account. A small charge is made for handling the collection.

Under this arrangement the bank simply collects the draft and the seller waits until payment has been received. If the seller desires credit to his account for the proceeds of the draft at once, his bank will advance the face amount of the draft, if satisfied with his credit standing. The bank may be secured by the merchandise covered by the documents attached to the draft. The bank must be certain, however, that the seller's credit standing is satisfactory, because the buyer may fail to pay and the merchandise may depreciate in value. When the bank advances the funds, the account of the seller is credited with the face amount of the draft. When payment is effected the principal amount is used to retire the bank's advance. The interest that has accrued for the length of time the advance has been outstanding, plus the collection fee are charged to the seller's account.

TRAVELERS' LETTERS OF CREDIT

In addition to issuing commercial letters of credit, a bank may also extend credit in a somewhat similar manner through the issuance of travelers' letters of credit (Figure 130A). A travelers' letter of credit is an especially prepared form of letter addressed by the issuing bank to its correspondent banks throughout the world shown in a list of correspondents carried by the traveler. The letter introduces one or more individuals and authorizes its bank correspondents to pay clean demand drafts drawn by any one of the named individuals on the issuing bank. The drafts must bear the date and number of the credit and the total of the drafts drawn may not exceed the amount of the credit. Drawings must be made on or

Figure 130A Travelers' Letter of Credit (front)



No. F R 0000 $ 5 000.*

THE FIRST NATIONAL BANK OF CHICAGO

TRAVELERS LETTER OF CREDIT

Chicago Ill. U S A July 15

To Our Correspondents

Gentlemen

We take pleasure in introducing to you

James B Rowland or Dorothy C Rowland * * * * * *

to whom kindly furnish such funds as may be required up to an aggregate amount of Five Thousand * * * * * * * * * * * * * *

United States Dollars against his drafts on

The First National Bank of Chicago Chicago Illinois plainly marked as drawn under this Letter of Credit

Such drafts so drawn and negotiated by you not later than December 31 ------- shall be honored by us on condition that each draft be signed in your presence the beneficiary's signature verified with specimen on our Letter of Identification bearing the same number as this Credit and the amount thereof endorsed on this Letter of Credit. Your charges if any are to be paid by the beneficiary.

When exhausted this Letter of Credit must be canceled and attached to the final draft.

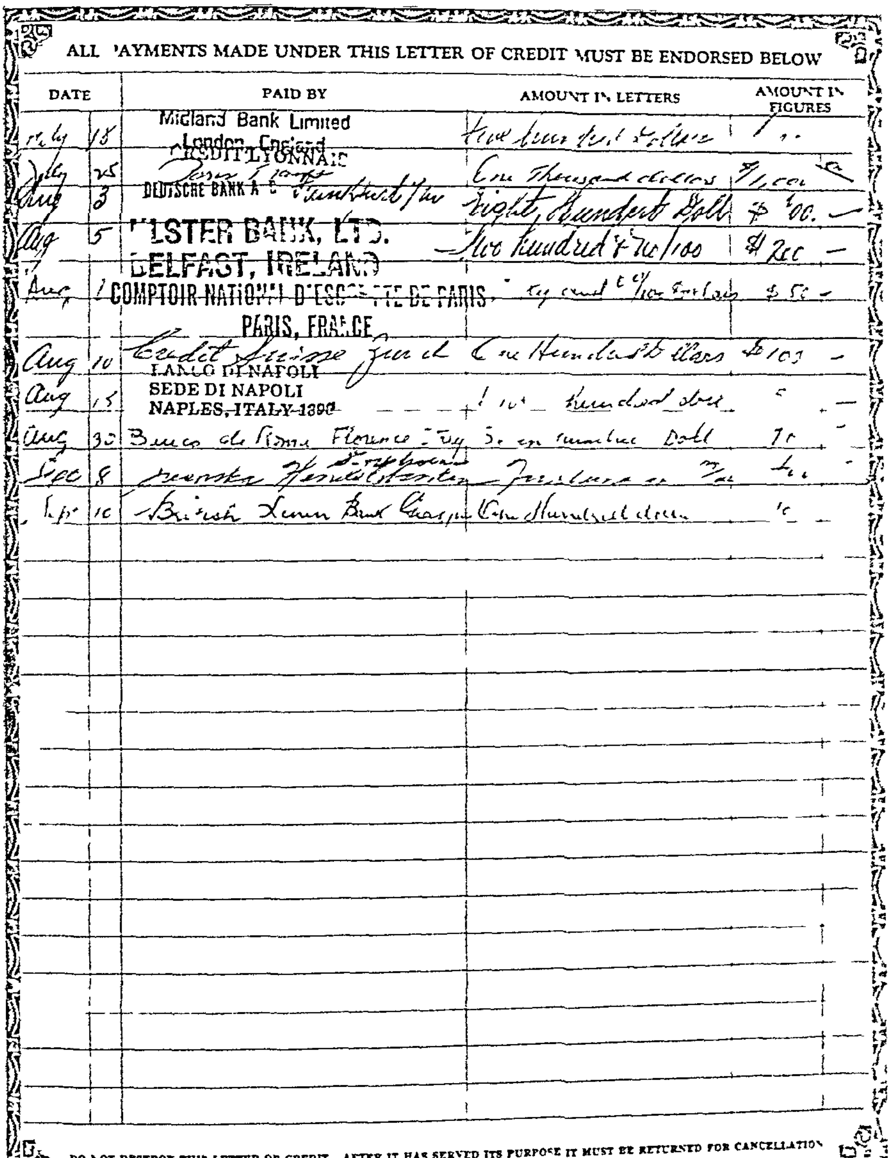
Yours respectfully

SPECIMEN

before the expiration date stipulated in the credit. Clean drafts, previously mentioned, are drafts which are unaccompanied by documents of any kind. Travelers' letters of credit are often called or referred to as circular letters of credit.

Letter of Identification. In conjunction with the travelers' letter of

Figure 130B Travelers' Letter of Credit (*reverse*)

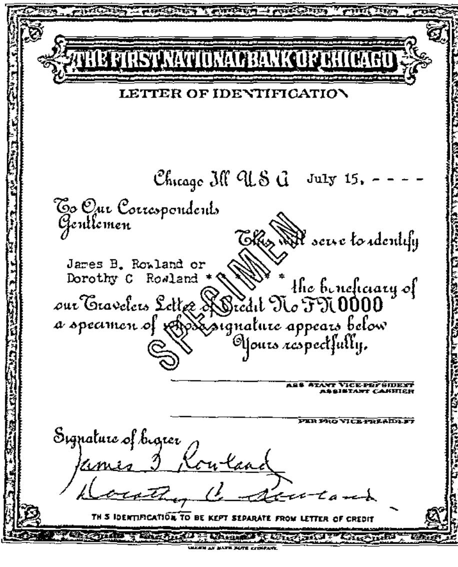

ALL PAYMENTS MADE UNDER THIS LETTER OF CREDIT MUST BE ENDORSED BELOW

DATE		PAID BY	AMOUNT IN LETTERS	AMOUNT IN FIGURES
July	18	Midland Bank Limited London, England		
July	25	CREDIT LYONNAIS	One Thousand dollars	$1,000
Aug	3	DEUTSCHE BANK A. G. Frankfurt	Eight Hundred Doll	$800
Aug	5	ULSTER BANK, LTD. BELFAST, IRELAND	Two hundred & no/100	$200
Aug	7	COMPTOIR NATIONAL D'ESCOMPTE DE PARIS PARIS, FRANCE		$50
Aug	10	Credit Suisse	One Hundred Dollars	$100
Aug	15	BANCO DI NAPOLI SEDE DI NAPOLI NAPLES, ITALY		
Aug	30			
Sept	8			
Sept	10		One Hundred dollars	

DO NOT DESTROY THIS LETTER OF CREDIT AFTER IT HAS SERVED ITS PURPOSE IT MUST BE RETURNED FOR CANCELLATION

credit, a letter of identification (Figure 131) is issued which bears the date of issuance, number of the letter of credit and the signature of the traveler In addition, both letters bear two signatures of individuals authorized to sign such instruments Each bank correspondent appearing in the list of correspondents carried by the traveler, has in its possession a list of individuals on the staff of the issuing bank which shows the signatures of those authorized to sign the letters of credit and the letters of identification The bank correspondents also have in their files facsimiles of these letters

Figure 131 Letter of Identification Used in Conjunction with a Travelers' Letter of Credit


THE FIRST NATIONAL BANK OF CHICAGO

LETTER OF IDENTIFICATION

Chicago Ill U S A July 15, - - - -

To Our Correspondents
Gentlemen

This will serve to identify
James B. Rowland or
Dorothy C Rowland * * * * * the beneficiary of
our Travelers Letter of Credit No FN 0000
a specimen of whose signature appears below
Yours respectfully,

SPECIMEN

ASSISTANT VICE-PRESIDENT
ASSISTANT CASHIER

PER PRO VICE-PRESIDENT

Signature of bearer
James B Rowland
Dorothy C Rowland

THIS IDENTIFICATION TO BE KEPT SEPARATE FROM LETTER OF CREDIT

How the Credit Operates

The circular letter of credit is carried by a traveler for the purpose of obtaining funds for traveling, living expenses and other incidentals while on a domestic or foreign trip either for business or for pleasure. By means of the travelers' letter of credit, a traveler is able to obtain immediate encashment of his drafts *only* at the banks shown in the list of correspondents. The draft drawn by the traveler is signed in the presence of the negotiating banker and the traveler's identity is established by comparing his signature on the draft with the one appearing in the letter of identification which he carries *separately* from the letter of credit.

The negotiating bank establishes the genuineness of the traveler's letter of credit and the letter of identification by comparing the official signatures on the letters with those in the authorized list of signatures with which it has been provided by the issuing bank. The authenticity of the two letters is also verified by the negotiating bank by comparing the instruments with the facsimiles in its files which it has received from the issuing bank.

The amount of each draft negotiated, the date of negotiation, and the name of the negotiating bank must be endorsed on the reverse (Figure 130B) side of the letter of credit by the correspondent bank paying the draft. There is no obligation on the part of the bank which issues the letter of credit to pay drafts negotiated after the credit has expired or which exceed the amount of the letter of credit.

When a draft properly drawn is presented for payment at the counter of the issuing bank, the presenter is reimbursed and the account of the customer is charged with the amount of the draft plus the issuing bank's commission.

Illustration: Assume that a traveler visiting Paris needs 100,000 French francs. He draws a dollar draft upon the American bank which issued his particular letter of credit, and presents it to the American bank's correspondent in Paris. The Paris bank satisfies itself regarding the traveler's identity and then pays him the equivalent of his dollar draft in French francs. The traveler thus has the funds he requires. The Paris bank proceeds to forward the draft to the American bank for payment. The American bank, upon receipt of the draft, may simply credit the account of the Paris bank upon the books of the American bank, or may remit in accordance with instructions.

To protect the issuing bank, the applicant for the letter of credit may deposit cash for the full amount of the credit, assign a savings account, deposit readily marketable securities as collateral, or simply sign a guar

Figure 132 Guaranty Signed by the Purchaser of a Travelers' Letter of Credit

CHICAGO ______ July 15, ______ 19__

TO THE FIRST NATIONAL BANK OF CHICAGO
CHICAGO 90 ILLINOIS

In consideration of your having granted to ______ me ______ a Letter of Credit in favor of ______ Dorothy C. Row and or myself ______ a copy of which appears on the reverse side hereof we I, James B. Row and ______

hereby agree to its terms and bind ourselves to pay on demand any and all sums that may from time to time be drawn under said letter together with your charge or commission of 1% min $10 00 per cent. In the event of loss of this letter of credit ___I___ agree to pay all expense incurred in stopping payment on same and if any payments are made against the Credit, so lost or stolen by any bank or bankers observing the usual precautions and before the receipt of any such notice to indemnify and save harmless yourselves and your correspondents from any loss or liability incurred thereby Having deposited herewith as collateral security

*

*

*

*

*

*

*

Which ______* hereby give the said THE FIRST NATIONAL BANK OF CHICAGO its assign or assigns, authority to sell, or any part* thereof upon the maturity of any of the obligations contemplated above, or at any time thereafter at public or private sale, without advertising the same or demanding payment, or giving notice and to apply so much of the proceeds thereof to the payment of such indebtedness as may be necessary to pay the same with all interest due* thereon* and* also* to* the payment of all expenses attending the sale of the said securities, and in case the proceeds of the sale of the* said securities shall not cover the principal, interest and expenses ______ promise to pay the deficiency forthwith after such sale.
*

We hereby agree that we shall be jointly and severally liable to you for the payment of all sums at any time drawn under said letter and that the individual liability of each of the undersigned shall not be limited to the amount which the undersigned respectively shall draw but shall apply to all sums drawn by any of the undersigned.

James B Rowland

James B Rowland

SPECIMEN

anty (Figure 132) to pay the drafts as they are presented When the applicant merely signs a guaranty without depositing cash or other collateral, the bank must know that the applicant has sufficient financial standing to warrant his receipt of such credit

TRAVELERS' CHECKS

Although some travelers have been successful in cashing their personal checks, they usually fortify themselves by carrying travelers' checks. These are the most popular and convenient vehicles in which travel funds are carried as they are probably the safest and most readily accepted substitutes for currency. They are honored by banks, hotels, travel agencies, railroad and steamship companies and in most stores and shops catering to tourists. Travelers usually pay cash for travelers' checks at the time they are purchased—rarely are the checks issued on an unsecured basis or against the purchaser's guaranty that they will be paid for at a later date.

Denominations. Institutions selling travelers' checks ordinarily issue them in denominations of $10, $20, $50 and $100, and collect a commission for the service. Perhaps one of the most distinctive features of travelers' checks issued by The First National Bank of Chicago (Figure 133) is that each denomination is identified by a different color. The variation in colors minimizes the possibility of confusion in handing out a hundred dollar check instead of a ten.

Protection against Forgery. There are two places on the face of the check for the signature of the purchaser. The First National Bank of Chicago travelers' check is signed at the time of purchase by the traveler on the line at the lower left. When the check is presented for encashment, it is countersigned on the line at the upper left in the presence of the person who cashes it. A comparison of the countersignature with the original signature of the traveler must satisfy the person cashing the check before payment will be effected. Additional protection is afforded by the travelers' checks illustrated as the original signature must necessarily be covered by the signer when the check is being countersigned.

Travelers' Checks Cashed Abroad. Regulations of some countries suffering from a shortage of American dollars often stipulate that a traveler cashing a travelers' check may only be paid the equivalent amount in the currency of the country at the prevailing market rate. Recently some relaxation of this restriction has been evidenced toward non-residents who have been permitted to exchange dollar travelers' checks for dollar currency in an increasing number of foreign countries.

Travelers' Checks versus Travelers' Letters of Credit. Preferences of travelers vary with respect to these two types of instruments. Both have advantages which are attractive to travelers.

Figure 133 Denominations of Travelers' Checks (*issued by The First National Bank of Chicago in four distinct colors*)

The traveler or business man who wishes to have at his disposal a sizable amount of funds would choose a travelers' letter of credit as it provides a reserve fund or a traveling checking account. It also serves as a letter of introduction to the vast network of bank correspondents from the issuing bank. The credit itself is not a negotiable instrument and therefore does not possess the flexibility of a travelers' check. Furthermore, it is only available at a bank whereas travelers' checks have wider acceptability and are negotiable instruments.

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chapter XXI

BUYING OPEN MARKET COMMERCIAL PAPER

"OPEN MARKET COMMERCIAL PAPER" DESCRIBES THE SHORT-TERM, self-liquidating promissory notes of business enterprises sold directly by the borrower or through commercial paper brokers to banks, other business corporations, foundations, pension funds, estates, and other institutional investors for investment purposes

HISTORY OF THE COMMERCIAL PAPER MARKET

Until shortly after the Civil War, nearly all merchandise obligations were paid by six and eight months' promissory notes or trade acceptances[1] These instruments represented the original form of commercial paper handled by the first note brokers The early open market paper of this character appeared in the New York City dry goods market. Then came the endorsed notes and trade acceptances of other prominent lines of business activity—concerns handling tobacco, hides and leather, groceries, sugar, whisky, and diamonds[2] Today financially responsible businesses follow the general practice of borrowing funds from their banks in order to take advantage of all cash discounts on merchandise purchases There is no easier way of earning a profit In the early part of the nineteenth century, discount terms had still to be created and used

The original practice of selling endorsed receivables and trade acceptances to outside banking institutions through the medium of commercial paper brokers developed somewhat over 170 years ago[3] It evolved from

[1] See Chapter XVI

[2] Roy A Foulke, *The Commercial Paper Market* (New York Bankers Publishing Company, 1931), chap 7

[3] A Maryland law case mentions "dealers in negotiable paper' who handled *bills of exchange and promissory notes* in Georgetown, D C., as early as 1793 Two cases

the need for credit by the growing industrial and commercial enterprises, manufacturers, importers, and wholesalers located in the larger cities along the Atlantic seaboard. They required outside credit to carry their merchandise through seasonal peaks and then, when the merchandise was sold, to carry the receivables of their distant country customers, who made purchases only once or twice a year on the customary six or eight months' terms. At the same time it provided banking institutions, even in those early days, with a desirable form of self-liquidating secondary reserve.

Since the turn of the century, open market commercial paper has served the particular needs of commercial banks and trust companies as an ideal form of secondary reserve just as effectively as in earlier days. During the money panic of 1907, during those trying months in 1914 when the New York Stock Exchange was closed and there was no free and open market for the securities of even the most widely known corporations, during the readjustment years of 1920 to 1921 when merchandise valuations were falling and falling fast, and during the troubled times of our more recent Great Depression when the very solvency of thousands of our banking institutions was open to serious question, open market commercial paper was paid at maturity with clocklike precision and gave holding banks millions of dollars weekly to assist in meeting their unusual demands. The self-liquidating character and relatively short maturity of open market commercial paper and the uniformly inherent strength of the borrowing units, combined with the fact that commercial paper, with the exception of the promissory notes of personal loan companies, is rediscountable at the Federal Reserve Banks when the maturity is not more than ninety days distant, have made this form of investment ideal during periods of economic uncertainty as well as during periods of prosperity.

MECHANICS OF INVESTING IN COMMERCIAL PAPER

Correspondents Act for Some Banks

A banker who has surplus funds to invest in commercial paper but who is situated some distance from the nearest reserve city might not feel

decided in the Massachusetts Supreme Court mention "brokers" who were handling *promissory notes* at least as early as 1807. However, the first mention of a "note broker" who was dealing in *commercial paper* occurred in New York City in 1810. Albert O. Greef, *The Commercial Paper House in the United States* (Cambridge: Harvard University Press, 1938), chap. 1.

close to the commercial paper market He might also feel that he lacked the means of investigating the credit standing of concerns offering their paper in the open market Consequently he might ask a correspondent bank in New York, Chicago, Philadelphia, Boston, or San Francisco to purchase $25,000 or $100 000 of paper for the account of his bank. In such cases the investing bank, however, takes all the risk, as purchases of paper are made for the "account and risk" of the investing institution Smaller banks rarely make any suggestions to their city correspondents regarding purchases except the following (1) the amount to be invested in commercial paper, (2) denominations desired, (3) rate of interest preferred, and (4) maturity When buying for correspondents, city banks often buy paper of their own depositors whenever possible, as they feel especially close to such risks

Bankers Prefer to Select Their Own Commercial Paper

Many bankers, however, are more interested in making their own selections of commercial paper Such a banker with surplus funds available for conservative investments gets in touch with one or several commercial paper brokers, asking for the names of the corporations whose notes are currently available, and also with the corporations that sell their notes direct to investing institutions

Until around 1932 or 1933, offering sheets of the various commercial paper brokers were mailed to buying or prospective buying banks at periodic intervals, generally weekly Besides listing the names of the concerns issuing notes these offering sheets also generally gave (1) location of the concern (2) line of business, (3) rate of interest carried, (4) maturity date, and (5) denominations of notes, and sometimes (6) the amount of paper currently offered by each concern With respect to denominations, the offering sheets might read as follows "We offer the following paper in denominations of $2,500, $5 000, and $10 000, subject to prior sales or change in rate For the past two decades or so, there has been a greater demand for commercial paper on the part of banks than could be supplied Consequently brokers at times have had a nominal and often no floating supply of paper As a result the distribution of offering sheets was discontinued for many years Often a block of $500,000 or $1,000 000 of paper of some well-known corporation, which a broker was assured he would receive on a definite day, would be sold even before delivery to the commercial paper house In 1957 several commercial paper brokers again began to use offering sheets

Today the amount of commercial paper offered by a borrower is always an even amount—$100,000, $500,000, or $1,500,000. These sums are divided into notes of various denominations to meet the anticipated needs of small, as well as large, buying banks. When the early endorsed

Figure 134 Early Offering Sheet of a Commercial Paper Broker

LIST OF PAPER OFFERED FOR DISCOUNT, BY

B. M. JACKSON & CO., BANKERS,

SUCCESSORS TO JACKSON & BUTTS,

No. 38 WEYBOSSET STREET, Bank of North America Building,

SUBJECT TO PREVIOUS SALE.

Providence, R. I. Feb 11 1865

Telegraph the numbers of the pieces discounted

NO	RATE	PROMISER OR ACCEPTOR.	DRAWER OR ENDORSER	DUE.	AMOUNT
1	8	Hunt Tillinghast & Co.	Ashaway Mfg. Co.	May 7	11500
2	"	Do.	Lafayette Reynolds	June 11	4000
3	"	Earl P. Mason	G. M. Richmond & Co.	Aug 7	5000
4	"	Do.	Do.	" 31	5000
5	"	Union Horse Shoe Co.		July 30	5000
6	"	Isaac Hartshorn	Morton C. Fisher	May 7	4000
7	"	Do.	Do.	" 11	4000
8	8½	Atlantic De Laine Co.	Geo. W. Chapin	Aug 9	5000
9	"	Do.	Do.	" 17	10000
10	8	Byron Sprague	N. T. Potter	June 9	2500
11	9	Bailey & Southard	Albinola & Bailey	" 10	5000
	To	Mess Paul Whitin & Sons			

notes and trade acceptances were being distributed, the amounts were invariably odd. Brokerage offering sheets as late as 1870 listed notes for sale in such amounts as $1,843, $2,538, and $3,840, and in all cases the offering sheet also listed the names of "promisor and endorser," or "drawer and acceptor." See Figures 134 and 135 for examples of early and current offering sheets.

When a banker decides upon certain purchases, he immediately wires

the broker at the broker's expense Most of the commercial paper brokers have traveling salesmen, who keep larger banks and smaller, but more or less consistent buyers, in close touch with the names available for purchase at the moment.

Commercial paper brokers guarantee the genuineness of all notes sold, but there their responsibility ends Care is taken in investigating the credit

Figure 135 Current Offering Sheet of a Commercial Paper Broker

GOLDMAN, SACHS & CO.
Members New York Stock Exchange
Established 1869
20 BROAD STREET NEW YORK 5 N. Y
Telephone WHitehall 4-2300

BOSTON
PHILADELPHIA

CHICAGO
ST LOUIS

We offer, subject to prior sale, the short term commercial paper notes of the following outstanding nationally known companies In addition, the notes of other prominent companies are available and we invite your inquiry

At 3 7/8% Discount	Maturity
CALIFORNIA PACKING CORPORATION, SAN FRANCISCO, CALIF	JANUARY
CONTINENTAL CAN COMPANY, INC , NEW YORK, N Y	DECEMBER
ENDICOTT JOHNSON CORPORATION, ENDICOTT, N Y	JANUARY
THE MANHATTAN SHIRT COMPANY, NEW YORK, N Y	DEC & JAN
SPERRY RAND CORPORATION, NEW YORK, N Y	DECEMBER
STOKELY-VAN CAMP, INC , INDIANAPOLIS, IND	DECEMBER
UNITED MERCHANTS AND MANUFACTURERS, INC , NEW YORK, N Y	JANUARY

At 3 3/4% Discount	
CALIFORNIA PACKING CORPORATION, SAN FRANCISCO, CALIF	NOVEMBER
CONTINENTAL CAN COMPANY, INC , NEW YORK, N Y	NOVEMBER
THE EMPORIUM CAPWELL COMPANY, SAN FRANCISCO, CALIF	OCT. & NOV
ENDICOTT JOHNSON CORPORATION, ENDICOTT, N Y	NOVEMBER
INTERNATIONAL SHOE COMPANY, ST LOUIS, MO	OCTOBER
LIBBY, MCNEILL & LIBBY, CHICAGO, ILL	NOVEMBER
R J REYNOLDS TOBACCO COMPANY, WINSTON-SALEM, N C	NOVEMBER
J P STEVENS & CO , INC , NEW YORK, N Y	OCTOBER
STOKELY-VAN CAMP, INC , INDIANAPOLIS, IND	NOVEMBER

Financial statements and information sheets on the foregoing companies are available upon request

Please wire or phone us at our expense

standing of every issuer whose paper the brokers handle. Should any financial embarrassment occur, however, the banks holding the notes assume the loss. Some bankers rely entirely upon the opinion of correspondents as to the responsibility and the credit standing of the issuers of notes. Others rely entirely upon the suggestion of the broker as to what paper should be purchased. Others make their own customary thorough investigations and arrive at their own independent conclusions.

Corporations Selling Commercial Paper Direct

Shortly after the General Motors Acceptance Corporation was organized in 1919, it set up a department to sell its own commercial paper directly to banks and other institutional investors that had surplus funds available for short-term investments. In the early nineteen-thirties Commercial Credit Company and C.I.T. Financial Corporation (then known as Commercial Investment Trust, Inc.), which had been selling their commercial paper through brokers, began to sell some paper direct and later discontinued the use of brokers. By 1939 these three finance companies were selling more commercial paper in the aggregate than was being sold by all other open market borrowers through commercial paper brokers.

The direct sale of commercial paper has expanded greatly over the years as may be noticed from Figure 136. In December 1961, $1,711,000,000 of outstanding paper had been placed by brokers and $2,963,000,000 direct by nine finance corporations.

Finance companies are heavy users of borrowed funds at all times. The three finance companies mentioned above have been joined over the years by six others, which now borrow substantially in the open market and sell their promissory notes direct through their own organization, not using the services of commercial paper brokers. These six finance companies are: Associates Investment Company, General Electric Credit Corporation, General Finance Corporation, International Harvester Credit Corporation, and Pacific Finance Corporation. These corporations sell commercial paper with maturities ranging from 30 to 270 days, depending upon the requirements of the buyers.

Option Periods

When a banker has agreed to purchase notes from a broker, he has the privilege of returning any or all of the notes within ten days. These ten

days, called an "option period," allow the banker time to investigate thoroughly the credit standing of the borrowers and to decide whether the notes are ones he would like to keep The confirmation of sale by the broker generally contains an explanation reading about as follows "This option is given and accepted with the understanding that the paper returned under its provisions is to be for adverse credit reasons only The above notes if unmarked may be returned by giving notice to our office during banking hours on or before the dates specified against each note on this bill' Rarely are options renewed

A large percentage of the notes purchased by so-called "country" banks is delivered to the nearest reserve city bank correspondent or to the Federal Reserve Bank of the district for safekeeping By this process interest begins to run from the date of delivery If notes are mailed directly to the bank, interest for one or two days may be lost

Investigating the Commercial Paper Borrower

During the option period the credit department or the individual performing that function must work fast If the banker himself analyzes the risk, he secures from the commercal paper broker copies of balance sheets and income statements for the past one, two, or three years, together with the names of all the principal depository banks and such interim financial information as the broker might have on hand covering developments of the business since the last fiscal date In 1961, 0 6 per cent of the corporations that borrowed on the open market had a tangible net worth between $500,000 and $1,000,000, 25 1 per cent, between $1,000,001 and $5,000,000, 37 3 per cent, between $5,000,001 and $25,000,000, 13 3 per cent, between $25,000 001 and $50,000,000, and 23 7 per cent, in excess of $50,000,000 Since open market borrowers are the larger and better known corporations in their respective lines of business, a banker is always able to secure considerable information about them for a current credit analysis After he has obtained all available credit information from the note broker, he might take any one or all of the following five steps to complete his investigation and analysis

1 Obtain a credit report on the borrower, prepared by the Bank Service Department of the National Credit Office, Inc This department specializes in the investigation, analysis, and editing of comprehensive specialized credit reports on corporations that borrow in the open market[4]

[4] This department of the National Credit Office, Inc., is discussed on pages 99–100

2. Obtain a credit report from Dun & Bradstreet, Inc., to ascertain the paying habits, progress, and present financial condition of the concern and the record of its officers.

3. Write all of the depository banks, if the concern keeps accounts in five or fewer banks, and write a selected number in different centers, if there are more than five depository banks. These banks are requested to state their experience with the account and the basis on which loans are granted, so as to judge whether open market and direct borrowings are on a parity.

4. Write two or three correspondents in large centers, which have efficient credit departments, for their opinions of the note or notes that he has under option.

5. On the basis of all of the information that the credit department obtains in this manner and then analyzes, the banker takes his fifth and final step, which is to decide whether he will keep or return the note. If the banker receives any criticism whatsoever on a name or if any single feature of the risk, such as the experience or the records of the officers and directors, the method of operation, slow trade payments, or the financial condition, does not conform to standards set by the individual banker, he has the privilege of returning the paper to the broker any time before the option period expires.

More information of a detailed character is available for the analysis of the current credit standing of open market borrowers than on any other form of investment. If there is any criticism of a name, its commercial paper will not sell. Until the basis for that criticism is eliminated, brokers generally decline to handle the paper. This constant routine of credit investigation and analysis is applied so rigorously day after day to every piece of commercial paper sold that relatively few concerns are able, year in and year out, to keep their financial affairs in such healthy shape that their notes will sell readily at the current market rate. In fact, the credit standing of an open market borrower is being constantly and thoroughly investigated and analyzed by each of six distinct organizations. The investigation and analysis of any single member of one of these six groups may develop, point out, or emphasize facts or criticisms which then become more widely known and make the sale of additional commercial paper difficult or impossible to outside banking institutions. These six groups are the following:

1. The commercial paper broker who is handling the note.
2. Banking institutions that have the account.

3 Banking institutions buying the notes under option

4 City correspondents of the buying banks which are asked for their opinion

5 Current trade creditors

6 Mercantile credit agencies

The result is that any corporation that is able to sell its notes in the open market may be considered in that thin uppermost stratum representing the better credit risks in our commercial and industrial world This statement is not modified by qualifying features of general business conditions, broad market movements, or money rates, but is based solely on the credit responsibility of the concern itself Open market borrowers are the "cream of the crop" from a credit point of view

VOLUME OF OUTSTANDING COMMERCIAL PAPER

Since July 1918 the amount of commercial paper outstanding in the hands of paper-buying banks and other investing institutions has been compiled monthly by the Federal Reserve Bank of New York The high point as reflected by these figures was reached in May 1962, when $5,917,000,000 in commercial paper was outstanding Of this total, $1,869,000,000 had been placed through brokers and $4,048,000,000 directly by the issuing corporations The low point occurred in May 1933, when only $60,000,000 was outstanding This tremendous decrease was natural and clearly exemplified the unusually healthy, liquid character of open market paper as a secondary reserve even in times, as Henry George says, "of recurring paroxysms of industrial depression"

The volume of outstanding commercial paper has had two peaks, one in the latter part of 1919 and the early part of 1920, and the other in 1961 and 1962 The widespread speculation in commodities and land following the First World War necessitated the heavy use of short term credits by business enterprises, and the larger, well known, sound business concerns obtained a substantial portion of their temporary credit needs at the lowest possible interest rate by using the commercial paper market In January 1920, outstanding commercial paper amounted to $1,296,000,000 In 1922, the first year for which accurate records are available, 2,259 corporations used the open market

The relatively small amount of commercial paper held by commercial banks and trust companies in May 1933 was due to the depressed and embarrassed state of business activity, the liquidated condition of so

large a proportion of the business enterprises of the country, the rather dubious outlook for fundamental improvement which made itself felt in the small amount of forward business, the widespread low interest rates, and the tremendous sums of excess banking reserves. Liabilities of corporations had been gradually and steadily reduced. Such is the natural result of a serious depression. Debts were gradually paid off, and, as far as possible, new liabilities were avoided. Long-term borrowings virtually disappeared from the investment market, except for the Federal government and municipalities, which had problems of unemployment and tax deficiencies.

Figure 136 Commercial Paper Outstanding*

(In Millions of Dollars)

December of each Year	Sold Through Brokers	Sold Directly	Total
1950	$345	$ 575	$ 920
1951	449	882	1,331
1952	552	1,193	1,745
1953	564	1,402	1,966
1954	733	1,191	1,924
1955	510	1,510	2,020
1956	506	1,660	2,166
1957	551	2,115	2,666
1958	840	1,891	2,731
1959	755	2,975	3,730
1960	1,358	3,125	4,483
1961	1,711	2,963	4,674

* Source: Federal Reserve Bank of New York.

At the end of 1948 outstanding commercial paper amounted to $674,000,000. With one minor dip in 1954, outstanding paper reached new highs in each of the following ten years. At the end of 1960 the figure stood at $4,483,000,000, at the end of 1961 at $4,674,000,000, and in May 1962, at an all time high of $5,917,000,000.

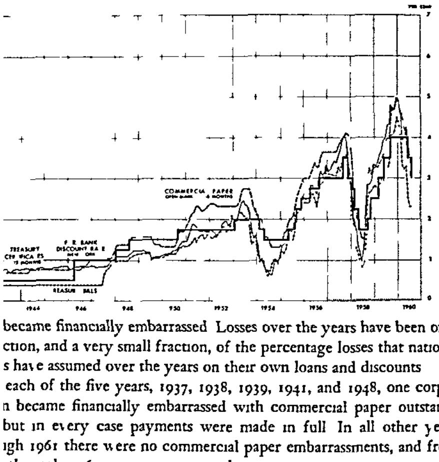
The current peak in outstandings is the result of the heavy borrowings of finance companies, a type of business that was hardly in existence in 1920. Whereas in 1922 there were 2,259 open market borrowers, in 1961 there were only 349. Of these borrowers, 131 were finance companies of one kind or another, and of these, 9 were selling their paper direct. Figure 136 shows the outstandings at the end of each year from 1950 to 1961 of the finance companies that sold their paper directly. If there were some way to segregate the outstandings of finance companies that sold their notes through brokers, and add that figure to the out-

lings of finance companies that sold their paper direct, it would be
er how much finance companies have dominated the commercial
r market in recent years

HEALTHY ATTRIBUTES OF COMMERCIAL PAPER

nce 1936 the record of investments in commercial paper from the
t of view of losses has been most unusual In that year a loss of
50 was assumed by investing banks in the paper of one corporation

gure 137 Chart Showing Interest Rates on Prime Commercial
–6 *months*), Treasury Certificates, Treasury Bills, and the Discount
Rate of the Federal Reserve Bank of New York (*1943–1960*)



became financially embarrassed Losses over the years have been only
ction, and a very small fraction, of the percentage losses that national
s have assumed over the years on their own loans and discounts
each of the five years, 1937, 1938, 1939, 1941, and 1948, one corpo-
n became financially embarrassed with commercial paper outstand-
but in every case payments were made in full In all other years
igh 1961 there were no commercial paper embarrassments, and from
through 1961 not a penny was lost on investments in commercial
r As a result average dollar losses on open market commercial paper
the years have been infinitesimal
ie fact that losses have been so nominal has resulted largely from the

stringent requirements that a corporation must meet to sell its notes in the open market and from the consistent opportunity under the option system of allowing investing institutions sufficient time to confirm the inherent soundness of each risk. Furthermore, in purchasing open market paper, a banker is not subject to the influences encountered in direct contact with depositors. Cold judgment is substituted for sentiment, with consequent modification of losses.

Are there any other reasons for this unusual record which has made open market commercial paper one of the strongest forms of secondary reserves for banks and trust companies? Is commercial paper so very different in character and results from guaranteed mortgage bonds, high-grade long-term securities, or even Federal government securities? There are certain fundamental differences.

No Fluctuation in Principal

The only return on open market commercial paper is the interest return. Unlike bonds and government securities, the value of commercial paper remains at par, 100 cents on the dollar, irrespective of varying economic conditions. The market value of bonds and government securities depends upon a wide variety of factors, including interest trends, business conditions, the earnings and the current financial standing of the issuer in case the issuer is a business corporation, and the general financial outlook. There is always the possibility of some gain by the rise in the market value of bonds, but, likewise, there is always the possibility of some loss. Unlike commercial paper, the principal investment fluctuates from day to day and from week to week. The return can never be measured until the security is sold. Unfortunately for holding banks, the need for cash is often greatest and most widely spread just about the time that a downward movement has occurred in the bond market. This condition is proverbially expected by the experienced banker. Moreover, there is no cost in buying or selling commercial paper, no commission charges.

Credit Facts Readily Available

The very mechanics of investing in commercial paper makes it generally possible to obtain more comprehensive financial information and credit data on such borrowers than on concerns with long-term securities outstanding. A buying banker always has close contact with the borrower either through the medium of the commercial paper broker or

directly This relationship is important, extremely valuable, and practical. When purchasing bonds of industrial and utility concerns, a banker can rarely obtain information other than that available in the existing statistical services

Open market commercial paper has continuously represented an ideal investment medium for the secondary reserves of banking institutions. The paper is short-term, self-liquidating, sound, non speculative, and rediscountable, with the exception of notes of personal loan companies, at Federal Reserve Banks when the maturity is ninety days or less away.

chapter XXII

THE LEGAL ASPECTS OF BANK LOANS

WHILE EVERY BANK LOAN INEVITABLY INVOLVES SOME RISK OF LOSS, that risk should relate only to the borrower's ultimate debt-paying ability and, if the loan is legally authorized and executed, should not extend to the validity of the bank's claim against the borrower. Although a banker rarely, if ever, extends credit to a borrower in whose integrity he does not have complete confidence, the case books are nevertheless replete with litigation involving bank loans. Banking transactions involving execution of instruments, endorsements, guaranties, and pledges are a most fruitful source of litigation. The use of well-drawn printed forms for routine transactions and consultation with legal counsel in unusual cases will do much to minimize losses from these causes.

EXECUTION OF NOTES AND OTHER FORMS

The rules generally applicable to the execution of other contracts apply to the execution of notes and other bank forms. For instance, if a person has signed a bank form, he will not be permitted to show that he did not know its contents; in the absence of fraud it is immaterial whether or not he has read it.[1] Of course, if the party signing the contract is prevented

[1] Restatement, Contracts, Par. 70, 4 R. C. L. 506; Williston on Contracts (3rd ed.), Par. 90A, 17 C. J. S. 487; Upton, assignee v. Tribilcock, 91 U.S. 45 (1875); W. T. Rawleigh Co. v. Washburn, 80 Mont. 308, 200 Pac. 1039 (1927); O'Reilly's Case, 258 Mass. 205, 154 N.E. 851 (1927); International Text-Book Co. v. Mabbott, 159 Wis. 423, 150 N.W. 429 (1915); Continental Ill. Nat. Bank v. Cardwell, 287 Ill. App. 227, 4 N.E. 2d 770 (1936); Vargus v. Esquire, 166 F2d 651 (1948), cert. den. 355 U.S. 813 (1949).

from acquainting himself with the contents by the fraud or artifice of the other party, he may avoid the contract [2] Accordingly, it is recommended that the ordinary bank forms, such as notes, guaranties, pledge agreements, and the like be plainly captioned as such and printed in large, easily readable type

Individuals

Insofar as individuals are concerned, it is, of course, important to ascertain that the person executing a note or other instrument has legal capacity to contract, that is, he is of age and is not incompetent Execution of an instrument on behalf of an individual by an agent or attorney in-fact should call for the examination by the bank of the power of attorney under which the agent desires to act, in order to ascertain that it covers the proposed transaction and is in full force and effect [3] The execution of an instrument by two or more individuals provides a frequent source of litigation to determine whether they are jointly or severally liable and whether they signed as co makers or as maker and guarantor [4]

Corporations

Where a corporation is executing a note or other instrument, the question as to whether one or more signatures may be required depends upon the corporation's bylaws or specific authority from its board of directors [5] The name of the corporation should be followed by the signature of the individuals signing on behalf of the corporation, and their titles should be clearly shown Otherwise, the individuals may be personally liable [6] The usual form of corporate execution where two signatures are required is as follows

[2] Black v W St L and P Ry Co., 111 Ill 351 (1884), Dickenson v Dickenson 305 Ill 521, 137 N E 468 (1922)

[3] Annotation Authority of Agent to Borrow Money for Principal 55A L R and 1215, Merchants National Bank v Nichols, 223 Ill 41, 79 N E 38 (1906) Joseph Bros Lumber Co v Wolberg, 259 Ill App 123 (1930)

[4] Grove v Chicago Title and Trust Company, 25 Ill App., 2d 402, 165 N E. 2d 603 (1960), Skolnick v Susco Production, 349 Ill App 402, 111 N E 2d 180 (1953) Peterson v Swanson, 259 Ill App 80 (1930)

[5] Independent Oil Men's Association v The Fort Dearborn National Bank, 311 Ill 278, 142 N E 458 (1924) (indorsement), Merchants National Bank v Nichols, 223 Ill 41, 79 N E 38 (1906), Annotation "Authority of corporate officers to mortgage or pledge corporate personal property," 62 A L R 2d 712

[6] Crawford Door Sales Co v Kowalik, 4 Ill App 2d 32, 123 N E 2d 111 (1955), Greenlee v Beaver, 334 Ill App 572, 79 N E 2d 822 (1948), Ruwisch v Theis, 325 Ill App 307, 60 N E 2d 108 (1945)

A B C CORPORATION
By John Jones
President
By Frank Smith
Treasurer

The general rule is that a private business corporation, unless forbidden or restricted by its charter, may borrow money for the purposes of its business and may issue its notes therefor.[7] While the officers of a corporation usually have no power to bind the corporation unless authorized by its bylaws or by resolution of the board of directors, it has been held that when a corporation borrowed money on its note executed by its president and secretary, and the proceeds of the loan were used for the purposes of the business, the note was binding on the corporation even though no bylaw or resolution authorized such borrowing.[8] In practice, however, it is essential that the lending bank satisfy itself that the borrowing corporation has the power to borrow money and that the officers who are to execute the note on behalf of the corporation are duly authorized to do so by the bylaws or resolutions of its board of directors.

In the case of short-term commercial loans to established mercantile corporations, the usual practice is merely to require the borrowing corporation to furnish a certified copy of a resolution of its board of directors authorizing certain officers to borrow money and execute notes therefor on behalf of the corporation, such certified copy being authenticated by the secretary or other officer having official custody of the corporate records and seal. Most banks, having their own printed form of general resolution conferring authority to open and maintain a deposit account, borrow money, and pledge property as collateral security, will require this resolution to be adopted by the board of directors of each of their corporate customers. A typical form of such a general resolution, embodied in certificate form, appears in Figure 138.

In the case of term loans, mortgages, and subordination agreements, it is generally desirable to require not only special resolutions authorizing the execution and delivery of the particular instrument involved, but also an opinion of the borrower's attorney that such execution and delivery have been duly authorized, that the instrument is binding upon the borrower in accordance with its terms, and that such terms are not in conflict

[7] R. C. L. 593; Fletcher, Cyclopedia Corporations (Publisher: Callaghan and Company, Permanent Edition, 1950), VI, Par. 2610.

[8] Scouton v. Stony Brook Lumber Co., 261 Pa. 341, 104 Atl. 548 (1918); 7 A. L. R. 1433, and note at 1446.

with any charter or bylaw provision of the borrower or any contract binding upon the borrower. In addition, term-loan lenders often require the borrower to furnish a certified copy of its charter and bylaws. Precautions of this kind are advisable to avoid the possibility of having the bank's loan subordinated to claims of other creditors or even to the claims of preferred stockholders, in the event the borrower gets into financial difficulty and it is then discovered for the first time that the bank's loan was made in violation of some indenture or preferred stock provision.

Figure 138 Form for a General Resolution

I, the undersigned, *Do Hereby Certify*, that the following is a complete, true and correct copy of certain resolutions of the Board of Directors of ____________________,
[illegible]

a corporation duly organized and existing under the laws of the State of ________________,
[illegible]

which resolutions were duly adopted at a duly called meeting of the said Board, held on __________,
[illegible]

19____, a quorum being present, and are set forth in the minutes of the said meeting; that I am the keeper of the corporate seal and of the minutes and records of this Corporation, and that the said resolutions have not been rescinded or modified.

Authorized signatures for indorsement

Be It Resolved, that ____________________________ (hereinafter sometimes referred to as the "Bank") be and hereby is designated a depositary in which the funds of this Corporation may be deposited by its officers, agents, and employees, and that such officers, agents, and employees shall be and each of them hereby is authorized to indorse for deposit or negotiation any and all checks, drafts, notes, bills of exchange, and orders for the payment of money, either belonging to or coming into possession of this Corporation. Indorsements for deposit may be by the written or stamped indorsement of this Corporation without designation of the person making the indorsement;

Authorized signatures on checks

Be It Further Resolved, that the ____________________________

____

____

____

____

(Titles of officers and/or other persons authorized to sign checks, e. g. President, Treasurer, etc., etc.; please indicate in what manner the above-named officers are to sign—singly, any two, or jointly, etc.)

of this Corporation (are) (is) authorized to SIGN ANY AND ALL CHECKS, DRAFTS, AND ORDERS, including orders or directions in informal or letter form, against any funds or accounts at any time standing to the credit of this Corporation with the Bank, and that the Bank hereby is authorized to honor any and all checks, drafts and orders so signed, including those drawn to the individual order of any such officer or other person signing the same, without further inquiry or regard to the authority of said officer or other person or the use of the checks, drafts and orders, or the proceeds thereof.

Authorized signatures on notes and obligations, etc.

Be It Further Resolved, that the ____________________________

____

____

____

(Please indicate in what manner the above-named officers are to sign—singly, any two, or jointly, etc.)

Long and Short Bank Forms

There is some diversity of opinion as to whether the ordinary printed bank forms should be short and succinct or should be so drawn as to embrace various events that may occur during the lifetime of the instrument. The advocates of the short form reason that it is safer to use a simple form which clearly sets forth the particular relationship between the bank and the customer, relying upon custom, usage, and general principles of law to take care of extraordinary conditions or events. They further reason that since it is impractical to provide against every possible contingency, a construction of the terms of the instrument favorable to the bank may be forfeited under the legal maxim: "If there be several things of the same class or kind, the expression of one or more of them implies the exclusion of all not expressed; and this even if the law would have implied all if none had been enumerated."[9]

The long-form advocates favor the use of forms that reasonably embrace all of the contingencies possible during the lifetime of the instrument. The growth of commercial banking has resulted in a great increase in the judicial review of banking transactions, and consequently, some bank attorneys have felt it desirable to include in their forms express provisions covering many different contingencies. In addition, the tendency of court decisions to uphold stipulations in note and guaranty forms, where not oppressive or violative of public policy, has lent impetus to the use of more specific, and hence longer, bank forms.

Collateral Form Note

The collateral form note is used by a bank in connection with its loans on securities, commodities, and other property susceptible of an actual or symbolic delivery to the bank, and consists, in major outline, of an ordinary promissory note combined with a pledge agreement. The agreement of pledge embodied in the collateral note usually provides that the property pledged to secure the indebtedness evidenced by the note shall likewise secure the payment of any and all other liabilities or obligations of the maker of the note to the bank or other legal holder of the note. Such a provision has been held to be valid and effective.[10] It enables the bank to use any surplus of the collateral security toward the

[9] American Well-Works v. Rivers, 36 Fed. 880 (1888).
[10] Union Brewing Co. v. Inter-State Bank, 240 Ill. 454, 88 N. E. 997 (1909); Annotation 87 A. L. R. *615*.

protection of the maker's other liabilities to the bank, including, for example, a prior loan or an overdraft It is, likewise, of great advantage to the bank in that it results in a pooling of all the maker's collateral security behind all the maker's notes held by the bank, relieving the bank from the restriction of using the proceeds of collateral security only toward the payment of the particular note in respect of which the collateral was pledged

It is usual to include in collateral form notes, as well as in unsecured notes, a provision giving the bank the right to set off and apply any cash balances due to the maker against the indebtedness evidenced by the note This right is sometimes conditioned on the note's having matured (either by lapse of time or by acceleration owing to some specified event of default), but more often it is an absolute right to set off at any time in the discretion of the bank, before as well as after the maturity of the note

The agreement of pledge ordinarily includes a power of sale and specifies the manner of holding a sale A stipulation providing that upon the maker's failure to pay the note at maturity, the collateral security shall automatically become the indefeasible property of the pledgee, has been held to be void [11] Unless the note so provides, the pledgee cannot become a purchaser at the sale [12] The terms of the note govern the rights of the parties as to the manner of the sale and must be adhered to strictly [13]

By the weight of authority a note is not rendered non-negotiable merely because it includes provisions governing the pledge and sale of collateral security [14]

While a pledgee of a certificate for shares of corporate stock duly endorsed undoubtedly has an implied right to transfer the shares into his own name in order to make them more readily available, it is not uncommon for a collateral form note to contain a provision expressly authorizing such a transfer The inclusion of such a provision is frequently of great benefit, for, without this, it is frequently difficult to procure a transfer of shares of stock prior to a foreclosure

[11] Moss Industries v Irving Metal Co, 142 N J Eq 704, 61 A2d 159 (1948) In Daly v Spiller, 119 Ill App 272 (1905), it was stated that such a provision was voidable, the decision being affirmed in 222 Ill 421, 78 N E 782 (1906) without adverting to this statement See also First Trust & Deposit Co v Potter 278 N Y S 847, 155 Misc 106 (1935)

[12] Annotation "Purchase by pledgee of subject of pledge, 76 A L R 705, 109 A L R 1106, 37 A L R 2d 1381, Columbia Casualty Company v Sodini, 159 Kan 478 156 P2d 524 (1945) (applying Illinois law) Wetherell v Johnson 208 Ill 247, 70 N E 229 (1904)

[13] Union Trust Co v Rigdon, (1879) 93 Ill 458 72 C J S 113

[14] Annotation 'Negotiability as effected by provisions of instrument in relation to collateral other than mortgage," 102 A L R 1095, 44 A L R 2d 57

A relatively short form of collateral note, which includes the various points discussed above, is set forth in Figure 139, while Figure 140 is a typical long form.

Figure 139 Short Form of Collateral Note

$\$$________________ Chicago, Illinois

________________ 19__

after date, the undersigned promises to pay to ______________________

THE SECOND NATIONAL BANK OF CHICAGO

or its order, at the office of The Second National Bank of Chicago in the City of Chicago, for value received ____________________ DOLLARS, with interest thereon from ________________ until paid at the rate of ________ per cent. per annum.

To secure the payment of this note, and of any other liability or liabilities of the undersigned to the holder hereof, due or to become due, or that may be hereafter contracted or existing, howsoever acquired by said holder, the undersigned has transferred, pledged and delivered to The Second National Bank of Chicago the following property to wit

(the market value of which is today $\$$______________) and now agrees that upon breach of any of the promises herein contained or upon failure to pay any of said other liabilities when due said Bank or the holder hereof may thereupon, or at any time or times thereafter, sell the said property or any part thereof, and any substitute therefor and any additions thereto, at any Brokers' Board, or at public or private sale, without notice, advertisement, or demand of any kind, and may apply the net proceeds, after deducting all costs and expenses for collection, sale, and delivery, to the payment of this note or of any or all of said liabilities, returning the residue to the undersigned on demand. Said Bank or the holder hereof may purchase any of said property at any such Brokers' Board or public sale. In case of decline in the market value of said property or any part thereof, the holder hereof may demand the pledge and delivery of additional property of quality and amount satisfactory to said holder, and the failure on the part of the undersigned to deliver such additional property on demand shall cause this note to become due and payable on demand. In case of the insolvency of the undersigned, any indebtedness due from the holder hereof to the undersigned may be appropriated and applied hereon at any time, as well before as after the maturity hereof. Before or after maturity, said Bank or the holder hereof, without notice, may at its option, transfer or register said property or any part or parts thereof, into its or its nominee's name, with or without indication of pledge.

____

____

Address ____________________

Guaranties

Guaranties are commonly used when a bank requires that its loan be guaranteed by some third person—thus placing the debt-paying ability of the third person (i.e., the guarantor), as well as that of the maker, behind the loan. Such guaranties are either *limited*—that is, restricted by their

terms to a particular note or amount or for a fixed time—or *continuing*—that is, continuing in effect as to future transactions until revoked by the guarantor. A continuing guaranty may be either limited or unlimited as to amount. A common illustration of a limited guaranty is the phrase "I hereby guarantee the prompt payment of the within note," which is

Figure 140 Long Form of Collateral Note

SINGLE PAYMENT—INTEREST BEARING)

$ New York, N. Y. 19

after date, for value received the undersigned promises to pay to ________ or order

at its office at N. Y. or at any of its other offices in the City of New York,

Dollars,

with interest from the date hereof until maturity at the rate of per cent. per annum payable at the end of each calendar month.

The following described property, to wit

printed on the reverse side of a promissory note and signed by the guarantor.[15] Such a guaranty obviously relates only to the particular note on which it is inscribed. Continuing guaranties are invariably embraced in a separate instrument and contain a phrase whereby the signer guarantees the prompt payment when due of any and all indebtedness (or all indebtedness up to a specified amount), present or future, of the borrower to the bank.

Since contracts of guaranty (other than surety company contracts) are frequently entered into solely for accommodation and without any participation by the guarantor in the benefits of the principal contract, the courts have tended to construe contracts of guaranty rather strictly against the party claiming under the contract. In fact, it has been said that "the surety is the favorite of the law." However, the rule of strict construction of contracts of guaranty will not be extended so as to invalidate a guaranty that is clear and unambiguous in its terms.[16] Nor is the principle that the undertaking of the guarantor is to be strictly construed intended to nullify the plain language of the instrument of guaranty.[17]

In some jurisdictions a guaranty is not binding upon the guarantor until notice of acceptance has been given by the party guaranteed,[18] although the Supreme Court of Illinois has held otherwise.[19] It is, therefore, prudent to include a provision in the continuing guaranty form waiving notice of the acceptance of the guaranty as well as notice of any advancements made thereunder.

If the party guaranteed has in his possession, as collateral, security belonging to the principal debtor and releases such security without first obtaining the consent of the guarantor, by the weight of authority the guarantor is discharged to the extent of the value of the security released.[20] Similarly, negligent loss of security, extension of the time of payment of the principal debt, and other occurrences have been held to

[15] Such a guaranty has been held to warrant that the note is valid and binding. Holm v. Jamieson, 173 Ill. 295, 50 N. E. 702 (1898).

[16] Peoria Savings, etc., Co. v. Elder, 165 Ill. 55, 45 N. E. 1083 (1897); Barrett v. Shanks, 382 Ill. 434, 47 N. E. 2d 481 (1943).

[17] Continental Ill. Natl. Bank, etc., v. Cardwell, 287 Ill. App. 227, 4 N. E. 2d 779 (1936).

[18] German Sav. Bank v. Drake Roofing Co., 112 Iowa 184, 83 N. W. 960 (1900); Vermont Marble Co. v. Bayne, 356 Ill. 127, 190 N. E. 291 (1934).

[19] Frost v. Standard Metal Co., 215 Ill. 240, 74 N. E. 139 (1905).

[20] Southern Surety Co. v. Merchants and Farmers Bank, 161 N. E. 842 Ind. (1928); Kirkpatrick v. Howk, 80 Ill. 122 (1875). See article by H. W. Arant, "Why Release of Security Discharges a Surety," 14 Minn. Law Review 725; 38 C. J. S. 1250; Barrett v. Shanks, 382 Ill. 434, 47 N. E. 2d 481 (1943).

discharge the guarantor. Hence, it is desirable to frame the language of the instrument of guaranty so as to preclude the discharge of the guarantor from all reasonably predictable contingencies.

A continuing guaranty, otherwise valid, contained a clause whereby the guarantor covenanted that he had no valid defense whatever to any action that might be instituted on the guaranty. In a suit on the guaranty it was held that although the stipulation waiving defense was invalid, the guaranty was enforceable.[21]

A typical so-called "long form" of guaranty in use by many banks today is set forth in Figure 141.

In sharp contrast in size to this long form of guaranty is the short form in Figure 142, which has been used, in substantially this form, with satisfactory results by one of the larger midwestern banks for over fifty years.

The advocates of the short form of guaranty contend that it is safer to train their discount clerks to be especially circumspect in the handling of guaranteed loans and securities pledged to these loans than to attempt to embrace all possible contingencies in the form of guaranty, and then discover that a particular event has occurred that is not covered by the language of the guaranty.

The long form of guaranty illustrated above includes an agreement of pledge as an integral part. When the short form is used, a separate pledge agreement must be procured from the guarantor if the performance of the guaranty is to be secured by the pledge of collateral security.

Corporate guaranties.—Corporations generally have no power to guarantee the obligations of or lend credit to another person or corporation (other than a subsidiary). This rule, of course, does not apply to corporations expressly organized for that purpose, such as surety or guaranty companies. The courts have held that contracts of suretyship or guaranty are beyond the powers of an ordinary corporation, since they constitute a devotion of the funds of the corporation to a purpose other than that authorized by its charter. The fact that the stockholders of the corporation have authorized the transaction does not validate an *ultra vires* contract of a corporation.[22] Even though all of the stockholders ratified the action of a corporation in giving an accommodation endorsement, it seems that the claim against the corporation on the endorsement, in the

[21] Nye, *et al*, v. Chase National Bank, 34 F.2d 435 (1929).

[22] See, for example, Culhane v. Swords Co., 281 Ill. App. 185 (1935); O'Connell v. Chicago Park District, 376 Ill. 550, 34 N. E. 2d 836 (1935); People v. Wiersana State Bank, 361 Ill. 75, 147 N. E. 537 (1935), Knaso v. Madison and Kedzie Bank, 354 Ill. 554, 188 N. E. 836 (1934); Thomas v. Railroad Co., 101 U. S. 71 (1879).

Figure 141 Form for Continuing Guaranty (*unlimited*)

In consideration of financial accommodations given or to be given or continued to________________________herein called "Borrower," by FIRST BANK AND TRUST COMPANY, New York, N. Y., herein called "Bank," the undersigned irrevocably and unconditionally guarantee to the Bank, payment when due, whether by acceleration or otherwise, of any and all liabilities of the Borrower to the Bank, together with all interest thereon and all attorneys' fees, costs, and expenses of collection incurred by the Bank in enforcing any of such liabilities.

The term "liabilities of the Borrower" shall include all liabilities, direct or contingent, joint, several or independent, of the Borrower now or hereafter existing, due or to become due to, or held or to be held by, the Bank for its own account or as agent for another or others, whether created directly or acquired by assignment or otherwise.

The undersigned waive notice of acceptance of this guaranty and notice of any liability to which it may apply, and waive presentment, demand of payment, protest, notice of dishonor or nonpayment of any such liabilities, suit or taking other action by the Bank against, and any other notice to, any party liable thereon (including the undersigned).

The Bank may at any time and from time to time (whether or not after revocation or termination of this guaranty) without the consent of, or notice to, the undersigned, without incurring responsibility to the undersigned, without impairing or releasing the obligations of the undersigned hereunder, upon or without any terms or conditions and in whole or in part:

(1) change the manner, place or terms of payment, and/or change or extend the time of payment of, renew or alter, any liability of the Borrower, any security therefor, or any liability incurred directly or indirectly in respect thereof, and the guaranty herein made shall apply to the liabilities of the Borrower as so changed, extended, renewed or altered;

(2) sell, exchange, release, surrender, realize upon, or otherwise deal with in any manner and in any order any property by whomsoever at any time pledged or mortgaged to secure, or howsoever securing, the liabilities hereby guaranteed or any liabilities (including any of those hereunder) incurred directly or indirectly in respect thereof or hereof, and/or any offset there against;

(3) exercise or refrain from exercising any rights against the Borrower or others (including the undersigned) or otherwise act or refrain from acting;

(4) settle or compromise any liability hereby guaranteed, any security therefor, or any liability (including any of those hereunder) incurred directly or indirectly in respect thereof or hereof, and may subordinate the payment of all or any part thereof to the payment of any liability (whether due or not) of the Borrower to creditors of the Borrower other than the Bank and the undersigned; and

(5) apply any sums by whomsoever paid or howsoever realized to any liability or liabilities of the Borrower to the Bank regardless of what liability or liabilities of the Borrower remain unpaid.

No invalidity, irregularity or unenforceability of all or any part of the liabilities hereby guaranteed or of any security therefor shall affect, impair or be a defense to this guaranty, and this guaranty is a primary obligation of the undersigned

This guaranty is a continuing one and all liabilities to which it applies or may apply under the terms hereof shall be conclusively presumed to have been created in reliance hereon As to each of the undersigned, this guaranty shall continue until written notice of revocation signed by such undersigned, or until written notice of the death of such undersigned shall in each case have been actually received by the Bank, notwithstanding a revocation by, or the death of, or complete or partial release for any cause of, any one or more of the remainder of the undersigned, or of the Borrower or of any one liable in any manner for the liabilities hereby guaranteed or for the liabilities (including those hereunder) incurred directly or indirectly in respect thereof or hereof, and notwithstanding the dissolution, termination or increase, decrease or change in personnel of any one or more of the undersigned which may be partnerships No revocation or termination hereof shall affect in any manner rights arising under this guaranty with respect to (a) liabilities which shall have been created, contracted, assumed, or incurred prior to receipt by the Bank of written notice of such revocation or termination or (b) liabilities which shall have been created, contracted, assumed or incurred after receipt of such written notice pursuant to any contract entered into by the Bank prior to receipt of such notice, and the sole effect of revocation or termination hereof shall be to exclude from this guaranty liabilities thereafter arising which are unconnected with liabilities theretofore arising or transactions theretofore entered into

In the event that the Borrower is a partnership, the term "liabilities of the Borrower" as used herein shall include all liabilities of any successor partnership or partnerships to the Bank, direct or contingent, joint, several or independent, now or hereafter existing, due or to become due to, or held or to be held by, the Bank, whether created directly or acquired by assignment or otherwise

The Bank at all times and from time to time shall have the right to require the undersigned to deliver to the Bank as security for the liabilities of the undersigned hereunder, collateral security, original or additional, satisfactory to the Bank

All property of the undersigned shall be held by the Bank subject to a lien and as security for any and all liabilities of the undersigned The term "property of the undersigned" shall include all property of every description, now or hereafter in the possession or custody of or in transit to the Bank for any purpose, including safekeeping, collection or pledge, for account of the undersigned, or as to which the undersigned may have any right or power The balance of every account of the undersigned with, and each claim of the undersigned against, the Bank existing from time to time, shall be subject to a lien and subject to be set off against any and all liabilities of the undersigned, and the Bank may at any time or from time to time at its option and without notice

appropriate and apply toward the payment of any of the liabilities of the undersigned the balance of each such account of the undersigned with, and each such claim of the undersigned against, the Bank. The Bank may at any time and from time to time, without notice, transfer into its own name or that of its nominee any of the property of the undersigned.

Upon the happening of any of the following events: the death or insolvency of the Borrower or the undersigned, or failure of the undersigned to deposit such collateral as may be demanded by the Bank, or suspension of business of the Borrower or the undersigned, or the issuance of any warrant of attachment against any of the property of the Borrower or the undersigned, or the making by the Borrower or the undersigned of an assignment for the benefit of creditors, or a trustee or receiver being appointed for the Borrower or the undersigned or for any property of either of them, or any proceeding being commenced by or against the Borrower or the undersigned under any bankruptcy, reorganization, arrangement of debt, insolvency, readjustment of debt, receivership, liquidation or dissolution law or statute,—then and in any such event, and at any time thereafter, the Bank may, without notice to the Borrower or the undersigned, make the liabilities of the Borrower to the Bank, whether or not then due, immediately due and payable hereunder as to the undersigned, and the Bank shall be entitled to enforce the obligations of the undersigned hereunder.

Upon nonpayment when due of any of the liabilities of the Borrower or the undersigned to the Bank, the Bank may immediately or at any time or times thereafter without demand or notice to the Borrower or the undersigned and without advertisement, all of which are hereby expressly waived, sell, resell, assign and deliver all or part of said "property of the undersigned" at any Brokers' Board or Exchange, or at public or private sale, for cash, upon credit or for future delivery, and in connection therewith may grant options. Upon each such sale the Bank may purchase the whole or any part of such property, free from any right of redemption, which is hereby waived and released.

In the case of each such sale, or of any proceedings to collect any liabilities of the undersigned, the undersigned shall pay all costs and expenses of every kind for collection, sale, or delivery, including reasonable attorneys' fees, and after deducting such costs and expenses from the proceeds of sale or collection, the Bank may apply any residue to pay any liabilities of the undersigned, who shall continue liable for any deficiency, with interest.

If claim is ever made upon the Bank for repayment or recovery of any amount or amounts received by the Bank in payment or on account of any of the liabilities of the Borrower and the Bank repays all or part of said amount by reason of (a) any judgment, decree, or order of any court or administrative body having jurisdiction over the Bank or any of its property, or (b) any settlement or compromise of any such claim effected by the Bank with any such claimant (including the Borrower), then and in such event the undersigned agree that any such judgment, decree, order, settlement, or compromise shall be binding upon the undersigned, notwithstanding any revocation hereof

or the cancellation of any note or other instrument evidencing any liability of the Borrower, and the undersigned shall be and remain liable to the Bank hereunder for the amount so repaid or recovered to the same extent as if such amount had never originally been received by the Bank

No delay on the part of the Bank in exercising any of its options, powers, or rights or partial or single exercise thereof, shall constitute a waiver thereof No waiver of any of its rights hereunder, and no modification or amendment of this guaranty, shall be deemed to be made by the Bank unless the same shall be in writing, duly signed on behalf of the Bank, and each such waiver, if any, shall apply only with respect to the specific instance involved, and shall in no way impair the rights of the Bank or the obligations of the undersigned to the Bank in any other respect at any other time

This guaranty and the rights and obligations of the Bank and of the undersigned hereunder shall be governed and construed in accordance with the laws of the State of New York, and this guaranty is binding upon the undersigned, his, their, or its executors administrators, successors, or assigns, and shall inure to the benefit of the Bank, its successors or assigns In the event that the Bank brings any action or suit in any court of record of New York State or the Federal Government to enforce any or all liabilities of the undersigned hereunder, service of process may be made upon the undersigned by mailing a copy of the summons to the undersigned at the address below set forth

The undersigned, if more than one, shall be jointly and severally liable hereunder and the term 'undersigned wherever used herein shall mean the undersigned or any one or more of them Any one signing this guaranty shall be bound hereby, whether or not any one else signs this guaranty at any time The term "Bank' includes any agent of the Bank acting for it

Dated New York, N Y

the____day of________________, 19__

____________________ ____________________

(Address)

____________________ ____________________

(Address)

____________________ ____________________

(Address)

hands of one not a holder in due course, is subordinate to all other bona fide claims against the corporation.[23]

Exceptions to the rule denying to a corporation the power to guarantee or lend its credit appear in instances where the court found that the act

Figure 142 Short Form of Guaranty

GUARANTY

The undersigned hereby requests ______________________ (herein called the "Bank") to give and continue to give ______________________

____

(herein called the "Borrower") credit, as the Borrower may desire and the Bank may grant, from time to time, whether to the Borrower alone or to the Borrower and others, and in consideration of any credit given, the undersigned hereby absolutely and unconditionally guarantees prompt payment when due and at all times thereafter of any and all existing and future indebtedness and liability of every kind, nature and character (including all renewals, extensions and modifications thereof) from the Borrower to the Bank, howsoever and whensoever created, or arising, or evidenced, or acquired, and the undersigned waives notice of the acceptance of this guaranty and of any and all such indebtedness and liability The undersigned hereby waives presentment, protest, notice, demand or action on delinquency in respect of any such indebtedness or liability, including any right to require the Bank to sue or otherwise enforce payment thereof

This guaranty is made and shall continue as to any and all such indebtedness and liability of the Borrower to the Bank incurred or arising prior to receipt by the Bank of written notice of the termination hereof from the undersigned, without regard to collateral, or security, or guaranties, or other obligors, if any, or to the validity or effectiveness of any and all thereof, and any and all such *collateral and security and guaranties and other obligors, if any, may, from time to time, without notice to or consent of the* undersigned, be sold, released, surrendered, exchanged, settled, compromised, waived, subordinated or modified, with or without consideration, on such terms or conditions as may be acceptable to the Bank, without in any manner affecting or impairing the liability of the undersigned. *It is agreed that the undersigned's liability hereunder is several and is independent of any other guaranties* at any time in effect with respect to all or any part of the Borrower's indebtedness to the Bank, and that the undersigned's liability hereunder may be enforced regardless of the existence of any such other guaranties

This guaranty shall also bind the heirs, personal representatives, successors and assigns of the undersigned and shall inure to the Bank, its successors and assigns

CHICAGO, ILLINOIS, ______________ 19___

______________________ (SEAL)

was actually in furtherance of the objects of the creation of the corporation or was reasonably calculated to promote the chartered enterprise. In an Illinois case[24] a corporation in the lumber business, in order to induce a contractor to purchase lumber from it for use on the job, guaranteed the contractor's performance of a building contract. In a suit against the lumber company on its guaranty, the court held that the guaranty was not *ultra vires* and that the lumber company was liable thereon. In passing, it should be noted that a few states, such as Illinois,[25] have substantially limited the defense of *ultra vires* by statute.

It is generally held that a corporation may guarantee the obligations of

[23] Eastern Trust & Banking Co. v. Guernsey, 144 Me. 135, 65 A2d 13 (1949); Martin v. Niagara Falls Paper Mfg. Co., 122 N. Y. 165, 25 N. E. 303 (1890); McQueen v. Dollar Sav. Bank Co., 133 Ohio St. 579, 15 N. E. 2d 529 (1928); Ballantine on Corporations (Publisher: Callaghan and Company, Revised Edition, 1946), Par. 101; Fletcher, *op. cit.*, VI, Par. 2493.

[24] Central Lumber Co. v. Kelter, 102 Ill. App. 333 (1902), aff'd 201 Ill. 503, 66 N. E. 543 (1903).

[25] Smith-Hurd Annotated Ch. 32, Sec. 157. 8. See Puerto Rico Indus. Develop. Co. v. J. H. Miller Mfg. Corp., 173 F. Supp. 596 (1959).

a subsidiary company[26] However the converse is not true, that is a subsidiary cannot guarantee the obligations of its corporate parent merely because the latter owns all of its outstanding stock[27]

The general rule denying the right of an ordinary corporation to become a guarantor must be borne in mind in considering the validity of subordination agreements and so-called consent to pledge agreements executed by corporations since these agreements partake of the nature of suretyship arrangements

Consent to-Pledge or Hypothecation Agreement

The consent to pledge or hypothecation agreement is used where collateral security belonging to some third party is tendered to the bank as security for a loan A bank cannot secure a valid pledge of property without the express or implied consent of the true owner

If a bank is put on notice that property tendered as collateral security does not belong to the person offering it as security for a loan there is the risk of having the true owner subsequently reclaim the property, or its value if it has been sold by the bank to satisfy the obligation Exceptions to this rule exist under certain circumstances, in the case of endorsed stock certificates[28] and negotiable instruments

Accordingly before accepting any property as security for a loan it is the general practice among banks to require the written consent of the owner, authorizing the borrower to pledge the property Figure 143 is a typical form of such a consent to-pledge agreement

These arrangements are somewhat in the nature of suretyship contracts that is the person who owns the property stands in the relationship of a surety to the extent of the value of the property Accordingly, the same degree of care should be exercised in the handling of these transactions as in the case of guaranties

Many banks do not ordinarily require that consent to pledge forms be executed by the registered owners of shares of corporate stock pledged

[26] General Inv Co v Bethlehem Steel Corp., 248 Fed 303 (1918) American Surety Co v 14 Canal St., Inc 276 Mass 119 176 N E 785 (1931) Fletcher *op cit.*, VI, Par 2593

[27] See *In re* Romadka Bros. Co 216 Fed 113 (1914) Fletcher *op cit.*, VI Par 2589 I Par 43 XIII Par 5811

[28] Uniform Stock Transfer Act, Secs 5 and 7 6 U L A 10 and 12 National Safe Deposit Co v Hibbs 229 U S 391 (1913) Annotation Effect of entrusting another with stock certificate endorsed or assigned in blank to estop owner as against a bona fide purchaser or pledgee for value 73 A L R 1405 Annotation "Pledge by transfer of instrument," 53 A L R. 2d 1396 1399

by stockbrokers, and it has been held that if a stockbroker wrongfully repledged to a bank a stock certificate, endorsed in blank, the owner could not reclaim the certificate.[29]

Figure 143 Form for Consent-to-Pledge Agreement

CHICAGO, ILL.________________19____

THE BANK OF CHICAGO
CHICAGO, ILLINOIS

Gentlemen:

In consideration of your making, renewing or extending a loan or loans to________________

____

____

hereinafter referred to as the "borrower", for which the following property belonging to me has been tendered to you as collateral *security, to-wit:*

____

____

____

____

____

and for the purpose of enabling said borrower to obtain credit therefore, I hereby certify that the said property has been duly assigned, released, transferred and delivered by me to said borrower, and by these presents, I do hereby assign, release and transfer unto said borrower all of my right, title and interest in and to said property, and hereby expressly authorize said borrower to pledge or hypothecate, all or any part of said property for the indebtedness aforesaid, and all renewals and extensions thereof, and also for any and all other indebtedness of the same borrower to you, whether alone or with others direct or indirect, absolute or contingent and howsoever acquired by you, created at any time before this authorization shall have been revoked in writing received by you and all renewals and extensions thereof, and I waive notice of all or any such indebtedness or extension, or renewal thereof.

Furthermore, I request, that you give, or continue to give said borrower, credit in the form of loans or renewals or extensions as aforesaid, and in consideration of all or any such credit so granted by you, I agree that all or any property pledged or hypothecated as aforesaid, shall be subject in your hands or those of your assignees, or pledgee or pledgees to all powers which would apply thereto by contract or otherwise if said property in fact so pledged or hypothecated stood in the name of said borrower himself and not in my name. The proceeds of all loans shall be accounted for and paid over to the borrower aforesaid, and said collateral securities may be disposed of and/or paid over, to or upon the direction of said borrower

This agreement shall be binding on my heirs, executors, administrators and assigns and inure to the benefit of your successors and/or assigns

________________________________[SEAL]

________________________________[SEAL]

WITNESS:

____

Subordination Agreement

It frequently happens, particularly in the case of relatively small corporations where the stock is closely held, that the principal stockholders may also occupy the position of creditors of the corporation by reason of advances made by them to the enterprise. When such a corporation applies to its bank for a loan, the bank may be unwilling to extend credit because of the inclusion of such indebtedness to stockholders among its liabilities. Stockholders in this position are often unwilling to capitalize

[29] Connolly v. Peoples State Bank, 260 Mich. 352, 244 N. W. 500 (1932), but see Edgerly v. First Nat. Bank of Boston, 292 Mass. 181, 197 N. E. 518 (1935), and Uniform Stock Transfer Act, Secs. 1 and 7, 6 U. L. A. 2 and 12 and cases cited thereunder. Attention is directed to the provisions of Section 8c of the Securities Exchange Act of 1934 and rules X-8C-1 and X-15C2-1 promulgated thereunder restricting the borrowing of a member of a national securities exchange or of a broker or a dealer who transacts a business in securities through the medium of any such member.

such advances but are willing to subordinate them to the loan that is sought from the bank. Under these circumstances, as well as under other similar ones, a so-called "subordination agreement" is used, whereby the stockholders subordinate the repayment of their advances to the corporation to the repayment of the loan to be made by the bank. A typical subordination agreement appears in Figure 144.

Figure 144. Form for Subordination Agreement

SUBORDINATION AGREEMENT

____________________ 19____

The Second National Bank of Chicago
30 South Judson Street
Chicago 90, Illinois

Gentlemen:

You are hereby advised that ______________________________ (herein sometimes called the "Company") is now indebted to the undersigned in the following amounts on the following described notes:

To induce you in your discretion to extend credit to the Company at any time, in such manner, upon such terms and for such amounts as may be mutually agreeable to you and the Company, the undersigned hereby agrees to subordinate and does hereby subordinate payment by the Company of all or any part of the above described indebtedness together with any and all other indebtedness of the Company now or hereafter incurred, created or evidenced to the undersigned (excepting indebtedness for salaries, if any, as may from time to time accrue) howsoever such indebtedness may be hereafter extended, renewed or evidenced to the payment to you of any and all indebtedness, direct or contingent, for which the Company may now or hereafter be under obligation to you, and in furtherance thereof does hereby agree not to ask, demand, sue for, take or receive all or any part of such indebtedness of the Company to the undersigned nor any security therefor unless or until any and all indebtedness of the Company to you now existing or hereafter arising shall have been paid in full, except the payment of current interest as hereinafter provided for.

The undersigned further agrees that upon any distribution of the assets or readjustment of the indebtedness of the Company whether by reason of liquidation, composition, bankruptcy, arrangement, receivership, assignment for the benefit of creditors or any other action or proceeding involving the readjustment of all or any of the indebtedness hereby subordinated, or the application of the assets of the Company to the payment or liquidation thereof, you shall

be entitled to receive payment in full of any and all indebtedness then owing to you by the Company prior to the payment of all or any part of the indebtedness hereby subordinated, and in order to enable you to enforce your rights hereunder in any such action or proceeding, you are hereby irrevocably authorized and empowered in your discretion to make and present for and on behalf of the undersigned such proofs of claims against the Company on account of the indebtedness hereby subordinated as you may deem expedient or proper and to vote such proofs of claims in any such proceeding and to receive and collect any and all dividends or other payments or disbursements made thereon in whatever form the same may be paid or issued and to apply same on account of any indebtedness owing to you by the Company.

The undersigned further agrees to execute and deliver to you such assignments or other instruments as may be required by you in order to enable you to enforce any and all such claims and to collect any and all dividends or other payments or disbursements which may be made at any time on account of all or any of the indebtedness hereby subordinated.

The undersigned hereby also agrees not to assign or transfer at any time while this agreement remains in effect any rights, claim or interest of any kind in or to any of the indebtedness hereby subordinated, either principal or interest without (1) first notifying you and (2) making such assignment expressly subject to this subordination agreement. The undersigned will, upon request from you, deliver any note or other evidence of the subordinated indebtedness to you.

*It is also agreed that the Company may pay and the undersigned may receive currently accruing interest after the date hereof on the subordinated indebtedness, provided the Company is not in default in the payment of any of its obligations to you or under any of the provisions of this agreement or the provision of any note evidencing its obligation to you.

This is a continuing agreement of subordination and you may continue, without notice to the undersigned, to extend credit or other accommodation or benefit and loan moneys to or for the account of the Company on the faith hereof until written notice of revocation of this agreement shall be delivered to you by the undersigned. Such notice of revocation shall not affect this agreement in relation to any obligations or liabilities of the Company then existing or any obligations or liabilities created thereafter pursuant to any previous commitment made by you to the Company or any extensions or renewals of any such obligations or liabilities, and as to all such obligations and liabilities and extensions or renewals thereof, this agreement shall continue effective until the same shall have been fully discharged with interest.

It is further understood and agreed that you may at any time, either before or after such notice of revocation, in your discretion renew or extend the time of payment of all or any existing or future indebtedness or obligations of the Company to you or waive or release any collateral which may be held therefor at any time and in reference thereto to make and enter into any such agreement

* When appropriate, this paragraph should be omitted.

or agreements as you may deem proper or desirable without notice to or further assent from the undersigned and without in any manner impairing or affecting this agreement or any of your rights hereunder

Yours very truly,

We hereby acknowledge receipt of a copy of the foregoing subordination agreement and agree that we will not pay any indebtedness subordinated by the foregoing subordination agreement except as there provided In the event of any breach of the provisions of the foregoing agreement, we agree that, in addition to any other rights and remedies you may have, all of our obligations and liabilities to you shall without notice or demand become immediately due and payable unless you shall otherwise elect

By

The sole function of the subordination agreement is, as the name suggests, to render the claims of the persons executing the agreement subordinate to those of the person in whose favor the agreement is executed From the lending bank's standpoint, it has an additional advantage in that it tends to quicken the interest of the principals in the success of the business by increasing the possibility of their individual loss in the event of a failure of the enterprise Subordination agreements are sometimes entered into by non stockholding creditors, particularly in the case of finance companies, as an inducement to a bank or other lender to extend credit.

According to the text of the form above the party signing the agreement purports to subordinate his claim only in favor of the bank's claims, and no reference is made to the possibility that there may be other claims of third parties against the corporation in existence at the time the corporation fails However, since such third parties, or "outside" creditors, have never agreed to subordinate their claims to that of the bank, their claims and the bank's claim will necessarily rank on a parity in any liquidation or winding up of the corporation Accordingly, since the bank can

be paid no faster than such outside creditors, the effect of the execution of the subordination agreement is automatically to subordinate the claims of the party signing the subordination agreement to *all* other debts of the corporation. For this reason, a provision is included in the subordination agreement giving the bank the right to file a claim upon, and receive the dividends on, the subordinated indebtedness in any bankruptcy or other winding-up proceeding.

The following example will serve to illustrate the practical working of a subordination agreement. The Jones Shoe Co., Inc., goes into bankruptcy owing the Second National Bank $100,000 for moneys loaned. Harry Jones, the president and principal stockholder of the corporation, is a creditor of the corporation to the extent of $50,000 for advances made by him on open account. At the time the shoe company borrowed the $100,000 from the Second National Bank, the bank required Jones to subordinate the repayment of his $50,000 advance to the bank's loan to the concern. The shoe company has accounts payable to trade creditors amounting to $150,000. Its assets will liquidate for $125,000 after expenses of administration.

The bank files its claim for $100,000 against the bankrupt estate, and the trade creditors file their claims, which total $150,000. If Jones should file his $50,000 claim against the bankrupt estate, the bank could successfully object to its allowance on a parity with the claim of the bank because of the subordination agreement. However, the claims of the bank and that of the trade creditors are on a parity; hence, the claim of Jones would be allowed as a junior claim, entitled to receive dividends only after the claims of the bank and the trade creditors had been paid in full. If handled on this basis, the subordination of Jones's claim would naturally have inured to the benefit of the trade creditors as well as the bank, since the total claims entitled to participate in the distribution of the assets of the bankrupt estate would have been diminished by the amount of Jones's claim—that is, $50,000. Hence, since the assets of the bankrupt estate were liquidating for $125,000, the bank and the trade creditors would receive a dividend of 50 per cent on their claims.

Since the subordination agreement contains a provision authorizing the bank itself to file a claim on the subordinated indebtedness, in actual practice a claim would ordinarily be filed against the bankrupt estate by Jones on his claim for $50,000, and such claim would then be assigned by Jones to the bank. Generally little difficulty is experienced in securing the cooperation of the party signing the subordination agreement (Jones, in our illustration) in filing the claim and making the assignment described. He

recovers nothing personally on his claim in any event and, hence, is usually willing to fulfill his agreement with the bank. Should he refuse to do so, or should he be under some disability rendering him unable to do so, the bank can always file the claim itself under the power given in the subordination agreement. Since the subordination agreement is a contract between Jones and the bank for the exclusive benefit of the latter, Jones's claim can thus be proved on a parity with the claims of the bank and the trade creditors so long as the bank itself does not object. Under these circumstances the claims against the bankrupt estate amount to $300,000, since all of said claims are on a parity, a distribution of 41 666 per cent would be made on the claims The bank then would receive a dividend of $41,666 66 on its own claim, in addition to the dividend of $20,833 33 which would be paid on the Jones claim, making a total recovery by the bank of $62,499 99 on its $100,000 loan, as compared with a total recovery of only $50,000 if the Jones claim had not been properly subordinated

While it has been held that a court of bankruptcy will not digress, in the administration of a bankrupt estate, to settle collateral disputes,[30] agreements of subordination have frequently been considered and given effect by the courts in the administration of bankrupt estates.[31] Furthermore, it has been held that the provisions of Section 65a of the Bankruptcy Act, providing for the equal distribution of dividends, do not preclude the bankruptcy court from considering and giving effect to the provisions of a subordination agreement.[32]

SET OFF OF BANK DEPOSITS

Since a bank account creates the relationship of debtor and creditor between the bank and the depositor,[33] the rules applicable to an account between debtor and creditor generally apply It is well settled that the

[30] *In re* Railroad Supply Company, 78 F2d 530 (1935), Goldenberg v Westover, 150 F2d 388 (1945)

[31] *In re* Aktiebolaget Krueger & Toll, 96 F2d 768 (1938), *In re* Hicks-Fuller Co., 9 F2d 492 (1925) Federal Deposit Insurance Corporation v Department of Financial Institutions, 113 Ind. App 14, 44 N E 2d 992 (1942), International Telephone & Telegraph Corp v Holton, 247 F2d 178 (1957)

[32] Bird & Sons Sales Corporation v Tobin, 78 F2d 371 (1935), Sampsell v Imperial Paper Corp., 313 U S 215 (1941), Annotation "Power of Bankruptcy Court to adjudicate equities among creditors in distribution of dividends," 100 A. L. R. 660, *In re* Dodge Freedman Poultry Company, 148 F Supp 647 (1956)

[33] Scammon v Kimball, 92 U S 362 (1875), People *ex rel.*, v Farmers State Bank, 338 Ill. 134, 170 N E 236 (1930), People v West Side Trust and Savings Bank, 376 Ill 339, 33 N E 2d 607 (1941)

bank may offset and apply any money on deposit with it and belonging to the depositor to the payment of any debt due from the depositor to the bank. In the absence of an agreement to the contrary, a general bank deposit may therefore be applied to the payment of a mature debt without the consent of the depositor—notwithstanding the fact that, by so doing, the depositor's account is exhausted and his outstanding checks are consequently dishonored.

As a general rule a debt, in order to be set-off, must be due in the absence of a specific agreement between the bank and the borrower. While there is a sharp division of opinion among the courts on the subject, it has frequently been held that if the debtor is insolvent, the deposit may be offset even though the debt is not due.[34] As pointed out above, a bank frequently provides in its note forms that it shall have the right to offset and apply any deposits at any time, whether the customer's indebtedness is then due or not. Such stipulations have been held to be valid by the courts.[35]

A peculiar situation arises when an insolvent depositor dies before the maturity of the note. While there is an irreconcilable conflict of decisions on the point, the best rule seems to be that the death of the depositor does not deprive the bank of the right of offset even though there may be debts outstanding against the estate of a higher rank than that due the bank, and it has accordingly been held that the bank may plead the depositor's debt to it in offset to an action by the administrators of his estate.[36]

Of all the various aspects of the principle of set-off in banking law, its application in cases where the depositor becomes bankrupt has undoubtedly given rise to the most litigation. In order fully to comprehend the operation of the principle of set-off as it applies in cases where the borrower from the bank is adjudicated a bankrupt, it is necessary to have in mind the provisions of the Bankruptcy Act relating to what are called "preferences."

The keynote of the Bankruptcy Act of the United States, in common with bankruptcy legislation everywhere, is the equitable distribution of the bankrupt's assets among his creditors. As a general rule a solvent debtor may lawfully prefer one creditor over another; that is, he may make a payment to or give security to one of his creditors while ignoring

[34] Annotation "Bank's right to set off unmatured claims as against receiver, assignee for benefit of creditors, or trustee in bankruptcy of insolvent depositor," 37 A. L. R. 2d 850.

[35] 37 A. L. R. 2d 864.

[36] Annotation "Bank's right to apply or set-off deposit against debt of depositor not due at time of his death, 108 A. L. R. 778; Paton's Digest, II, p. 3409.

others Where a debtor, having so preferred some of his creditors over others, subsequently goes into bankruptcy, the preferential payments or transfers of security may, under certain conditions, be recoverable from the preferred creditor or creditors, as a fraud under the Bankruptcy Act The provisions of the Bankruptcy Act that apply to such transactions are found, in part, in Section 60, according to which a "preference" has occurred if a debtor, being insolvent, makes a payment to or gives security to a creditor within four months before the debtor's bankruptcy, the effect of which payment or transfer of security is to enable the preferred creditor to receive a greater percentage of his debt than other creditors of the same class If the creditor receiving the payment or benefiting from the transfer by way of security, had, at the time the payment was made or the security transferred, reasonable cause to believe that the debtor was insolvent, then the payment or security may be recovered from the preferred creditor by the trustee in bankruptcy of the estate of the debtor It should be noted that under the Bankruptcy Act a person is deemed "insolvent" if his assets, at a fair valuation, are not sufficient to pay his debts Thus, the bankruptcy definition of insolvency differs from the ordinary connotation of insolvency as mere inability to meet debts as they mature A preference that is so recoverable by a trustee in bankruptcy is called a "voidable" preference

To illustrate, let us assume that the Jones Shoe Co, Inc, owes the Second National Bank the sum of $10,000 for moneys loaned it by the bank The bank holds the shoe company's unsecured demand note evidencing the indebtedness The corporation sustains large losses and becomes insolvent While insolvent, the shoe company pays its indebtedness to the bank in full At the time it receives the payment, the bank is not aware of the fact that the corporation is insolvent Within four months after such payment, the shoe company is thrown into bankruptcy, and a trustee in bankruptcy is elected While the payment to the bank is a "preference," it is not a "voidable" preference since the bank did not know or have reasonable cause to believe that the shoe company was insolvent at the time it paid its indebtedness to the bank Accordingly, the trustee in bankrupcty cannot recover the $10,000 that the shoe company so paid the bank However, had the bank had reasonable cause to believe that the shoe company was insolvent when it paid its indebtedness, the trustee in bankruptcy could sue the bank and recover the $10,000 Of course, if the trustee in bankruptcy recovers the $10 000 from the bank as a "voidable preference," the bank is restored to its position as an unsecured creditor to the extent of $10,000 and, as such, is en

titled to share with other creditors in the distribution of the assets of the bankrupt estate.

Coming now to the application of the set-off principle, it is observed that Section 68a of the Bankruptcy Act provides as follows:

Sec. 68–Set-Offs and Counterclaims,

a. In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid.

It is well settled that the relationship between a bank and its depositor is that of debtor and creditor. Thus, when a customer of a bank makes a deposit in his checking account, an obligation springs up on the part of the bank to repay the deposit to the customer; that is, the bank *owes* the depositor the amount of his deposit. This, then, is an indebtedness that the bank may set off against any indebtedness that the customer may *owe* the bank—for example, a loan the bank may have made to the customer. Section 68a of the Bankruptcy Act, quoted above, gives recognition in bankruptcy matters to the general right of set-off.

As an illustration, let us assume that the Jones Shoe Co., Inc., owes the Second National Bank $10,000 on a loan, evidenced by an unsecured note due November 1, 1960. On October 25, 1960, the Jones Shoe Co., Inc., being insolvent, a petition in bankruptcy is filed against it by certain other creditors. On the day the petition in bankruptcy is filed, the shoe company has to its credit on the books of the bank, in its checking account, a balance of $2,750. On the concern's own books its balance in the bank is only $2,000, owing to the fact that it has outstanding checks against its account that have not yet been presented to the bank. Under these circumstances the bank may set off the balance of $2,750 and apply the latter amount toward the repayment of the loan of $10,000, even though the shoe company's note is not yet due by its terms and contains no provision for set-off. Accordingly, the bank may dishonor the outstanding checks upon presentation and may participate as a claimant to the extent of $7,250 with other creditors in the distribution of the remaining assets of the bankrupt estate. Inasmuch as the preference that the bank has thereby received is not a "voidable" preference, it is not recoverable by the trustee in bankruptcy of the shoe company.

A quotation from the decision of the United States Supreme Court in the celebrated case of Studley v. Boylston National Bank[37] will serve to illuminate the application of the set-off principle in bankruptcy cases.

[37] Studley v. Boylston National Bank, 229 U. S. 523, 528 (1913).

The Supreme Court of the United States, speaking through Mr Justic Lamar, summarized the law governing the set-off of bank deposits n bankruptcy cases as follows

That section [Section 68 of the Bankruptcy Act] did not create the right o set-off, but recognized its existence, and provided a method by which it coul be enforced even after bankruptcy What the old books called a right of stop page—what business men call set-off—is a right given or recognized by th commercial law of each of the states and is protected by the Bankruptcy Ac if the [bankruptcy] petition is filed before the parties have themselves give checks, charged notes, made book entries, or stated an account whereby th smaller obligation is applied on the larger The banker s lien on deposits, th right of retention and set off of mutual debts are frequently spoken of as thoug they were synonymous, while in strictness a set-off is a counterclaim which th defendant may interpose by way of cross-action against the plaintiff Bu broadly speaking it represents the right which one party has against another t use his claim in full or partial satisfaction of what he owes to the other That righ is constantly exercised by business men in making book entries whereby on mutual debt is applied against another If the parties have not voluntarily mad the entries and suit is brought by one against the other, the defendant, to avoi a circuity of action, may interpose his mutual claim by way of defense, an if it exceeds that of the plaintiff may recover for the difference Such counte claim can be asserted as a defense or by the voluntary act of the parties, becaus it is grounded on the absurdity of making A pay B when B owes A If th set off of mutual debts has been lawfully made by the parties before the [bank ruptcy] petition is filed there is no necessity of the trustee doing so If it h not been done by the parties then, under command of the statute [Bankruptc Act], it must be done by the trustee But there is nothing in Section 68a [of th Bankruptcy Act] which prevents the parties from voluntarily doing, before th petition is filed what the law itself requires to be done after proceedings i bankruptcy are instituted The Bankruptcy Act recognizes this right an it cannot be taken away by construction because of the possibility that it ma be abused The remedy against that evil is found in the fact that the Trustee authorized to sue and recover if it is shown that after insolvency the mone was deposited for the purpose of enabling a bank or other creditor to secure preference But to deny the right of set off in cases like this, would in man cases make banks hesitate to honor checks given to third persons, would pre cipitate bankruptcy and so interfere with the course of business as to produc evils of serious and far reaching consequence

Further, the law seems well settled that when a customer is indebted t a bank and makes deposits in his checking account in the ordinary cours of business within four months of his bankruptcy, the bank can offs and retain the balance on deposit in his account at the time the bank ruptcy petition is filed even though it had full knowledge of the cu

tomer's insolvency when the deposits were made.[38] However, if deposits are made within the four-month period while the bank has knowledge of the debtor's insolvency, and the deposits are made and accepted collusively for the purpose of building up the account so that the bank by offsetting can obtain a preference over other creditors, the bank will not be permitted to retain the moneys offset. The right of the bank to retain the depositor's balance depends on the purpose for which the deposits are made and accepted: whether they are made in the ordinary course of business with the expectation and intent that they may be withdrawn at will by the depositor; or whether, on the other hand, they are made to build up the account so that it can be applied to the payment of the bank's claim.[39]

With respect to the various forms referred to in this chapter, it should be noted that in jurisdictions where the Uniform Commercial Code has been adopted it may be necessary to modify these forms substantially in order to take into account the many novel terms and concepts used in the Code.

Obviously this chapter deals only with a few of the legal aspects of bank loans, for full coverage of this subject would be out of all proportion to the scope of this book. The problems discussed above, however, are among those that occur most frequently and hence may be of most interest to bankers generally.

[38] Continental & Commercial Bank v. Chicago Title & Trust Company, 229 U. S. 435 (1913); Annotation "Set-off by bank against bankrupt's deposit as a preference within the bankruptcy law," 85 A. L. R. 369; Joseph F. Hughes & Co. v. Machen, 164 F2d 983 (1947), cert. den. 333 U. S. 881 (1948); Widetzky v. Pilgrim Trust Co., 108 F2d 647 (1940).

[39] *In re* Almond-Jones Co., 13 F2d 152 (1926); Affirmed *sub nom*, Union Trust Co. v. Peck, *16 F2d 986 (1927)*, cert. den. 273 U. S. 767 (1927); and see Annotation "Set-off by bank against bankrupt's deposit as a preference within the bankruptcy law," 85 A. L. R. 369 at p. 378; Paton's Digest, II, p. 3412.

chapter XXIII

CAUSES OF BUSINESS FAILURES AND LOSSES ON BANK LOANS

THERE IS A CONTINUOUS RECORD OF THE COMMERCIAL AND industrial business failures in the United States since the year 1857.[1] A study of the number and the trend of these failures, the amount of their liabilities, and the comparison of the number of yearly failures with the constantly changing number of active commercial and industrial concerns is ever fascinating.

In 1932 there were 31,822 such failures, involving liabilities of $928,-312,000, the greatest number and the greatest amount of liabilities for commercial and industrial failures ever experienced in one year up to that time. That was also the year when wholesale commodity prices, stock market averages, advertisements in periodicals, attendance at motion picture theatres, purchases of new dresses, and general discouragement struck bottom—the year when the financial difficulties of banking institutions were multiplying and the year when the production and distribution of automobiles fell to a new low in well over a decade. Thirteen years later, in 1945, there were 810 failures, with liabilities of $30,395,000, the smallest number of failures and the smallest aggregate liabilities for any one year since the Civil War. By 1961 business failures had increased to 17,075, with aggregate liabilities of $1,090,123,000, a new all-time high.

Naturally the relationship between the number of failures and the num-

[1] This record is kept up to date by Dun & Bradstreet, Inc., and reported monthly, broken down by states, by specific lines of business activity, by the number and liabilities of failures in large cities, and by the number of failures per 10,000 listed businesses.

ber of listed business enterprises likewise has fluctuated from one year to another. In 1932, 1.54 per cent of all listed (i.e., listed in *The Reference Book*, published in July of that year by Dun & Bradstreet, Inc.) commercial and industrial concerns became financially involved, but by 1937 the corresponding figures, after five years of steady shrinkage, had fallen to 0.46 per cent, and by 1945 to 0.04 per cent. In 1961 the figures had increased to 0.64 per cent.

INTERPRETATION OF FAILURE RECORDS

Failure statistics have been analyzed and reanalyzed, interpreted and reinterpreted over the decades by year and by month. They have been studied and explained by students of business affairs, by men who knew little about business operations, by theorists, by practical business executives, by accountants, and by bankers. Failures, many theorists have freely informed us, are the result of incompetence; inexperience; lack of working capital; the increased intensity of competition; changes in the technique of production and distribution; changes in styles, fads, and habits; the introduction of substitute products; disasters, such as drought, severe windstorms, and fires; overtrading and undertrading; the personal extravagance of officers or partners; and, last but not least, "general business conditions." In other words, failures have been attributed to every reason under the sun.

Importance of Management

According to many diligent students, more business failures are caused by lack of working capital than by any other single factor. This cause has been singled out, emphasized, and delicately played upon, in contrast to many other causes, including incompetence, mental inertia, and inexperience on the part of those guiding the affairs of a business enterprise. Four examples will indicate that the finest plant, the most meritorious product, the greatest potential market, are liabilities under poor management; that management, and not this multitude of collateral factors, is fundamentally responsible for the success or failure of a business enterprise. Other factors help or retard progress in a competitive economy, but they are, in truth, of secondary importance.

Lack of Working Capital. If a business enterprise to manufacture bedroom furniture begins operations on a net working capital of $40,000 when a minimum of $90,000 is essential at this particular location, is not

the very organization of that concern with insufficient working capital the result of incompetence, inexperience poor management, and a lack of financial knowledge regarding the minimum of working capital needed to start operations with a reasonable expectation of success? On the other hand, if the business begins operations with a net working capital of $90,000 and in three years assumes losses that reduce the excess current assets to $40 000 are not those losses fundamentally the result of inefficient or incapable management somewhere along the line? Some analysts of business operations might be inclined to believe that these losses could result from factors other than poor managerial guidance or oversight such as extreme competition, a change in the technique of production and distribution, or changes in styles, fads, or habits of buyers Such explanations are taken up in the following three cases Here the lack of working capital in either instance is but an outward expression of the inexperience or inability of those who have charge of the welfare of the concern

Extreme Competition One ingenious student divides the causes of failure into two general categories—external and internal Among the so-called 'external factors'—that is, external to the management—is the increased intensity of competition, which is no clear fault of the business executive If such factors were actually beyond the control of business managers, fatalism would be the philosophy of business operations The expenditure of thought, energy, and conscious effort would be wasted

Consider the matter of extreme competition for a moment Suppose there were forty nine motion picture theatre supply houses in the United States These dealers handle a wide variety of supplies for the typical motion picture theatre projection machines seats, curtains, carpets, sets, projector repair parts, lamps, accessories, and carbon Suppose competition became keener and keener, and prices were cut, first on one product —carbon—and then on others—projector repair parts, lamps, and accessories Profits are turned into losses as the gross margin on carbons is cut from 30 to 5 per cent, and the gross margins on other important items also are greatly reduced First one concern and then another liquidates its affairs, pays its bills, pays the wages of its employees and its rent, pulls down the shades, and closes up shop Finally, thirty-nine remain How did that happen? Why were not the entire forty nine concerns forced to liquidate? Why only ten?

Obviously the ten that felt the results of the keener competition were the marginal concerns The managements of the liquidated concerns had lacked the aggressiveness to hold old business and had failed to acquire new business on more profitable collateral lines, such as air conditioning

and sound equipment which could have been sold to clubs, schools, and churches. Many times have the authors seen the weaker financial organization become stronger and finally work into healthy shape under the stress of intense competition, because that stress bred aggressiveness and a will to go after and acquire sales.

Only where the management is incompetent does a concern go under. Thus, is not a failure that is said to result from intense competition generally caused by poor or misguided management, where inertia has finally played its last leading role? Perhaps the financial condition of the concerns liquidated was not strong enough to stand up against the strain as long as the others. Again, that financial condition had been brought about by mistakes in policies, by inertia, by unskillful management guidance. If a particular business was started with too little funds, that again can be laid only at the doors of the owners; and if it lost funds so that it became weak financially, the management again must accept the ultimate responsibility.

Changes in Techniques of Production and Distribution. Likewise, failures said to result from changes in the techniques of production and distribution are classified time and again as due to external causes. Is not such a situation also the result of the lack of managerial foresight?

Here is a concern that has been engaged in the manufacture of vacuum cleaners for many years. The plant is an oldfashioned one operated in an oldfashioned manner, congenial for the employees when there are profits and paying low wages when there are none. A close personal, but hardly efficient, relationship exists between the owner and the men on the machines. Competitors have put in up-to-the-minute productive methods, whereby the work flows in one steady stream through the factory, each laborer carrying on one operation in which he has become expert. As a result, three times as many vacuum cleaners are turned out with the same number of men as in the oldfashioned enterprise. This change in production technique is surely a tribute to the live operating management in one case and an indication of sleepy unawareness in the other.

Being behind the times is no unusual attribute of the operating staff of a business that is sliding downhill. The oldfashioned manufacturer sells on terms of 2 per cent discount in ten days, net thirty days to wholesale distributors, and is finished with his vacuum cleaners as soon as they are delivered. The wide-awake concern is selling not to wholesalers, but direct to the retail trade, and has a definite planned connection with a national specialized finance company which offers each retailer its facilities in selling on the instalment plan. Distribution methods have changed, but

the oldfashioned enterprise is going to do its business "conservatively or not at all." Soon this enterprise will be doing none at all, because of managerial incompetence.

Changes in Styles, Fads, and Habits. Even failures that are thought to result from such external factors as changes in styles, fads, and habits may be laid nowhere except on the doorstep of the executive staff. There is no one policy to which the real executive gives more serious study and attention than just such changes. An aggressive, wide-awake management generally realizes that changes are taking place behind the scenes many months before they come to light. Consequently improvements and changes are made in the product well in advance of actual need. Studebaker, under aggressive management, went from wagons to automobiles and Curtiss from motorcycles to airplanes, each thereby removing himself from a declining industry.

Less awake executive staffs would have watched their sales shrink to the vanishing point and, without applying correctives, would have placed the onus on the "changing times." Every manufacturing or wholesaling business enterprise and most of the larger retailers that have been in existence twenty-five years or more have had to meet and overcome changes in the demands of customers, in manufacturing processes, and in methods of distribution. A constant change is in process, a change that is quietly taking place in the method of operation of all concerns with a firm grasp on reality. A business enterprise is the reflection of a guiding hand, just as much as a painting is of the artist, a book of the author, and a building of the architect. Furthermore, the business enterprise may be fully as much a work of art.

Two Basic Classifications of Failure Causes

This résumé of the causes of failures indicates that most of these causes, whether or not said to be beyond the control of management, are largely reflections of management's skill or lack of it. Only in rare instances is the management not to be scored because of a particular financial embarrassment. With this emphasis on the extreme importance of the knowledge, skill, experience, and aggressiveness of operating managements, the principal causes of failures fall into two basic classifications: (1) those that are manifestations of managerial ineptitude, and (2) those in which the skill of the management plays little or no part.

Figure 145 is a chart showing the primary and secondary causes of business failures falling in each of these classifications. Financial ratios, as

Figure 145 Chart of Causes of Business Failures

CAUSES OF BUSINESS FAILURES

I Causes of business failures, which are manifestations of managerial incompetence, inexperience, and neglect Failures resulting from this generic cause are broken down into twelve primary classifications, which indicate the particular nature of managerial incompetence, inexperience, and neglect.

(A) Manifestations reflected in balance sheet proportions

(1) Excessive liabilities, either current or current and funded (Measured by the relationship of current liabilities with current assets and with the tangible net worth, and by the relationship of the total of current and funded liabilities with the tangible net worth) Excessive liabilities are present in all failures. In many cases these obligations seem to be the apparent direct cause of the failure, in other cases, an overextended position is brought about by some one or several other causes, primarily
- (a) Overtrading
- (b) Losses or depletion in net working capital from any one or several of the causes outlined below under (B)

(2) Top-heavy fixed assets. (Measured by the relationship between the depreciated book value of the aggregate of fixed assets and the tangible net worth) This condition is brought about by
- (a) A desire to increase manufacturing capacities and facilities
- (b) A desire to enlarge or improve the appearance of retail establishments
- (c) Continual heavy losses, withdrawals, or dividends, which bring the tangible net worth to a vulnerable low level and which are represented largely by fixed assets

(3) Excessive inventories. (Measured by two relationships, inventory to net working capital and net sales to inventory) This condition is brought about by
- (a) Speculation in merchandise.
- (b) Poor judgment of markets—overbuying
- (c) Poor styling
- (d) Prices kept competitively high
- (e) Inventory is not kept up to date or balanced.

(4) Heavy receivables which include a large amount of bad debts or slow accounts. (Measured by the comparison of the average collection period with the terms of sale or by an aging of the accounts) Heavy losses may result from the extension of large credits to poor risks Sometimes, bad debt losses are written off through the income account occasionally through the surplus account, and at other times retained in the ledger to the bitter end The primary cause is
- (a) Inefficient credit and collection policies

(5) Excessive investments in and advances to subsidiary and affiliated concerns, which operate unprofitably or become financially embarrassed (Excessive investments in and advances to subsidiary and affiliated concerns are reflected by a reduction in net working capital)

(6) Excessive loans to officers, directors, or employees At times, funds are withdrawn in this manner to cover the actual living expenses of the controlling stockholder who has no other source of income At other times, the policy is followed without a clear conception of the possible disastrous effect.

(7) Insufficient net working capital, which is merely another way of saying excessive investments in slow assets, such as real estate, buildings, machinery, equipment, tools, furniture, fixtures, and miscellaneous receivables from officers, employees, directors, and subsidiary or affiliated enterprises, investments in miscellaneous unmarketable securities, and deferred assets.

(B) Manifestations reflected in operating figures

(8) Inadequate or declining net sales which result in net losses—also known as undertrading.

(9) Excessive fixed charges, which is another way of saying top-heavy fixed assets and excessive long-term liabilities. Depreciation and interest charges under such circumstances are heavy

(10) Excessive operating expenses, which might be caused by some one item of expense, such as salaries, by an inadequate mark-up, or by a combination of several items of expense all of which are out of proportion Poor cost accounting often is the underlying cause

(11) Continual losses, whether from operations and shown in the income account or from unusual causes and charged to surplus

(12) Constant and excessive withdrawals or dividend disbursements, which deplete the reserves and in time eat into the net working capital

All of these individual manifestations of managerial incompetence, inexperience and neglect are heightened and emphasized by the following seven factors of secondary importance In other words, the following seven factors, while never the direct causes of failure, are often the causes of bringing managerial errors into the limelight.

Secondary Factors
- (1) Business conditions such as a panic or a depression
- (2) Keen competition
- (3) Changes in the technique of production and distribution
- (4) Changes in styles, fads, and habits
- (5) Introduction of substitute products
- (6) Inadequate budgetary and accounting systems and controls
- (7) Fluctuations in the wholesale prices of commodities

II. Causes of failures in which managerial incompetence, inexperience, and neglect play little or no part

(A) Disasters, such as a flood, tornado, or earthquake Fires should always be protected against by fire insurance. Earthquakes and tornados in territories where they have once occurred should be protected against by insurance in the same thorough manner as fire Losses by burglary or fraud on the part of some officer or employee, likewise, should always be protected against by adequate burglary, casualty, fidelity and surety insurance.

discussed in Chapter VII, are not lifeless units of cold data They are mathematical representations measuring units and the concomitant results of operating decisions What the kilowatt is to electricity, the inch to linear measurement, the molecule to physics, the financial ratio is to the pecuniary condition of the business enterprise Moreover, every policy and decision of an executive staff has its reflection somewhere in the assets and liabilities of the balance sheet, the surplus account, or the income statement and consequently is disclosed by the healthy or the unhealthy proportions of the various assets liabilities, and expenses of a business enterprise

Manifestations of Managerial Ineptitude

With this background the causes of business failures that are manifestations of managerial ineptitude may be subdivided into (1) those reflected in the balance sheet and (2) those reflected in the operating figures These two subdivisions are then broken down into twelve fundamental expressions of managerial inefficiency, mental or physical inertia or ill-considered judgment. Each of the twelve subdivisions is brought to light by one or several of seven secondary factors or symptoms such as poor business conditions, competition, changes in the accepted techniques of production and distribution, changes in styles and habits, introduction of substitute products, inadequate budgetary and accounting controls, and fluctuations in wholesale commodity prices These seven factors are not basic causes but tend to emphasize the effects of first causes and bring them out in bold relief At times they are the background against which the initiatory principles of business management stand out

Excessive Liabilities The first manifestation of managerial incompetence, inexperience, or neglect given in the outline above is the growth in the liabilities of a business enterprise to a point where they have become distinctly excessive A business becomes financially involved when its liabilities are top-heavy, when invoices cannot be paid according to terms, when the interest on a funded debt cannot be met, and when the current or funded debt cannot be paid or refunded at maturity Because these definite financial obligations cannot be met, a petition in bankruptcy is finally filed either by the management of a business or by its creditors

The history of such a case would show that the liabilities had become heavy because of some one or several management decisions or because of lack of aggressiveness or preparedness to meet competitive conditions and practices Possibly the management in immediately preceding years had

drawn down excessive salaries, permitted excessive dividends or withdrawals, operated at a loss, speculated in merchandise, or had top-heavy funded debts and excessive fixed charges. In other words, along with excessive liabilities, there would be found underlying managerial decisions that had brought the enterprise to its final resting place.

Top-Heavy Fixed Assets. The second manifestation of managerial incapacity is found in top-heavy fixed assets. This condition invariably indicates a lack of net working capital and burdens the operating account with more than its normal share of yearly depreciation. Such a condition in a manufacturing enterprise results from the desire of the management to expand the capacity and the facilities of the concern generally during a period of good business. When the cycle turns, the concern is distressed by idle plant capacity. Such a situation is doubly vulnerable when new construction and additions to plant capacity are financed with borrowed funds. The same situation occurs with retail establishments when large sums are spent to improve the front or the inside furnishments of a store, when an addition is made to an old store, and when new units are taken over either by the purchase of the properties in fee or under leaseholds.

This condition may be brought about by continual heavy losses, withdrawals, or dividends for several years by the management of a business which at an earlier date had maintained a satisfactory relationship between its fixed assets and its tangible net worth. This is likely to happen particularly in family corporations, when funds must be withdrawn from the business for the actual living expenses of the family whether or not profits are earned. Also, this ailment frequently develops where the management through ignorance has failed to realize the disastrous effect of steady losses and excessive withdrawals or dividends.

Excessive Inventories. The third manifestation of managerial incompetence is found in excessive inventories. This condition may be brought about by the manufacture or distribution of too many products or lines for the size of the business; by building up unbalanced inventories; by speculation in merchandise—that is, by buying heavily in anticipation of a rise in prices, which often fails to materialize; by poor judgment of future markets—that is, by overbuying; by the production or handling of a product that is out of style or not in public demand; by unknowingly having prices that are competitively high; and by not keeping the inventory neat and up to date.

The inevitable conclusion of these interpretations of the outline is that the success or the failure of any business endeavor rests almost entirely in the hands of the operating management. The remaining nine manifesta-

tions of managerial decisions, policies and plans which are reflected in the balance sheet and income statement are just as vital as the three just explained They are the reflections of mental or physical inertia, too little aggressiveness, and the lack of knowledge of how to cope with the many causes of business variation

Secondary Factors

In the bracket at the right of the outline chart in Figure 145, on page 587, are given seven secondary factors that reveal and emphasize managerial inexperience and incompetence These symptoms, as distinguished from basic causes, tend to be drawn into the circle of primary causes and effects where operating managements lack knowledge and ability When managements are really capable, plan ahead diligently and skillfully, and keep their affairs in fairly sound financial condition, these seven factors can exert far less unfavorable pressure

Not one of these seven factors in itself causes a business failure Any one or several of them, however, might represent conditions that would be a test of the ability, foresight, skill, and knowledge of operating management An executive who would speculate in merchandise, who would purchase heavily in excess of his reasonable needs and whose business would subsequently become bankrupt with the ensuing drop in wholesale prices would certainly lack both knowledge and foresight The drop in wholesale prices would not have been the cause of the failure, but merely the means through which the inexperience of the management became evident. The fundamental error was in deciding to pile up a heavy inventory far in excess of reasonably legitimate needs

While the remaining six secondary factors are effective in a similar manner, perhaps no one of them is as serious as fluctuations in wholesale commodity prices in aggravating an unsound financial condition As a result, business failures usually decrease as wholesale commodity prices increase and increase as they decrease There is, however, a natural tendency for the number of failures to follow somewhat after the movement of prices

FAILURES AND WHOLESALE PRICES

The long decline in wholesale prices starting in the summer of 1929 came to an end in March 1933 The combined index of the wholesale prices of 784 commodities as computed by the Bureau of Labor Statistics,

with 1926 as the base, fell during this time from 96.5 in July 1929 to 59.8 in February 1933. As wholesale prices kept declining, the number of failures constantly grew. Each year from 1929 to 1932 registered an increase in the number of business embarrassments over the number for the preceding year, culminating in the 31,822 business embarrassments of 1932. From February to the end of 1933, wholesale prices of finished products, semimanufactured products, and raw materials were all headed generally upward. Consequently, with the resulting inventory profit of active concerns, the number of failures for the year, compared with the number of failures in 1932, dropped 37.5 per cent.

Rising Prices and Decreasing Failures

Wholesale prices continued to rise throughout 1934. From the Depression low of 59.8 in February 1933, the index of the Bureau of Labor Statistics rose to 70.8 per cent in December 1933, and to 76.9 in December 1934. The rise in this index during 1934 amounted to 8.6 per cent and was fairly continuous throughout the year. Conversely, the number of failures in 1934 declined to 59 per cent of the number of embarrassments in 1933.

The wholesale commodity price level continued upward in 1935, but most of the advance was concentrated in a relatively few commodity groups, particularly farm products and food. The sharp upward trend of 1933 had not tended to flatten out. The trend, however, was noticeably upward, and although the rise occurred in commodities that played a smaller part in inventory profits or losses, the 11,510 failures for the year were slightly below the number in 1934. The same trend continued into 1936. All commodities other than farm products and foods continued a moderate, but consistently upward, trend throughout the year. Failures dropped to 9,185, the lowest since 1920.

Falling Prices and Rising Failures

In 1937 the reaction occurred. Neither sales, net profits, nor the level of wholesale commodity prices keep on rising forever. A reaction must always take place. The upward trend reached an eloquent climax in April 1937, when President Roosevelt stated in a press conference that he believed prices had been rising too fast, particularly the prices of copper, steel, and durable goods.

Even before this memorable utterance–in fact, as early as the month of February–the price of cotton broadcloth seemed to be slipping. With

cotton mills sold ahead for two, three, four, and five months, no one had a clear conception of whether the break in the cotton goods market was temporary or whether it was the beginning of a more sustained, wider drop in prices Three months later the wholesale prices of copper, tin, cocoa, crude rubber, wool, wheat, butter, and steel scrap were selling at their highest points for periods ranging from six to nine years

The combined index of the wholesale prices of the Bureau of Labor Statistics reached a peak of 88 3 in April 1937 Then the fireworks started, and the price of commodity after commodity hit the sawdust trail By January 1938 the index had dropped to 80 9, a drop of approximately 8½ per cent, and by August 1939, to 75 0, a drop of 15 1 per cent

As wholesale prices receded, some fluctuation occurred in the number of monthly failures When compared with the number of failures for the corresponding months of 1936, some months were higher and some were lower By October 1937 when the effect of falling prices was widely realized, failures were running materially ahead of any corresponding period of the preceding year The full effect of decreasing prices was felt in 1938, when failures increased to 12,836, compared with 9,017 in 1937, an increase of 42 3 per cent

Rising Prices and Decreasing Failures

In August 1939 the Bureau of Labor Statistics index had dropped to 75 Prices continued a sideward movement until November 1940, when the early effects of purchases by the Allies began to be felt Between November 1940 and November 1941, the index rose from 79 6 to 92 5 The rise continued to 103 6 in February 1944 and then leveled off as a result of price control By June 1946 the index was 112 9 and then, with the elimination of O P A, jumped to 124 7 in July and 134 1 in October As wholesale prices went upward, failures decreased year by year—9 405 in 1942, 3,221 in 1943, 1,222 in 1944, and an all time low of 810 in 1945

Prices and Failures Since World War II

Since the end of World War II in 1945, we have had continuous inflation While there have been great fluctuations in the prices of the two thousand individual commodities that comprise our current wholesale price index, the over all index has been headed almost steadily upward

We have also had three minor recessions with higher business failures The first minor recession after the end of World War II occurred in

1948 to 1949. In these two years business failures increased from 5,250 to 9,246, and liabilities of business failures, from $234,000,000 to $308,000,000. The second recession took place from 1953 to 1954, when business failures increased from 8,862 to 11,086, and liabilities went up from $394,000,000 to $462,000,000. The third recession occurred from 1957 to 1958, ending around April-May 1958. Business failures in these two years expanded from 13,749 to 14,964, and liabilities increased from $615,000,000 to $728,000,000. In each of these three recessions the number of failures and their aggregate liabilities reached higher levels.

The last recession was the sharpest of the three. It was also the shortest. For eight months through April 1958, industrial production, sales, and inventories declined month after month. Then the turn-around suddenly took place. The upturn seems to have been initiated at least partially by a broad switch in inventory policy in commerce and industry. Inventory liquidation had accelerated to a record rate in the first quarter of 1958. Managements soon learned, however, that consumer demand was not falling at the same rate as inventories. Simultaneously a renewed high level of Federal government spending was inaugurated, resulting in a Federal deficit of $12,500,000,000 for the fiscal year ending June 1959.

Correlation between Prices and Failures

The tendency toward an inverse correlation between the level of wholesale commodity prices and the number of yearly business embarrassments is a natural one. A substantial number of the approximately 2,600,000 active commercial and industrial business enterprises of the country, probably 20 or 25 per cent, are marginal enterprises. Some were organized with insufficient capital, some have taken losses for several years, some have paid excessive salaries, declared excessive withdrawals or dividends, some have incurred heavy liabilities, or carried inflated receivables. A moderate ailment will eliminate many of these marginal concerns from the circle of business competition. Conversely, any factor that will assist, ever so slightly, in turning a loss into a break-even operating statement acts like so much oxygen administered to a sick person: if enough oxygen is given, he might recover.

No one factor has such an immediate effect upon the well-being of a business enterprise as the level of prices of the raw material a manufacturing concern uses or the level of wholesale prices of the products a wholesale or retail concern handles. If the general level of prices of the products a concern is handling goes up, its own selling prices can be raised and an

unexpected profit thereby obtained on the inventory purchased at lower prices and already on hand. To a marginal enterprise, balancing itself on the brink of uncertainty, that means renewed vigor and a somewhat stronger lease on life. Conversely, when prices fall, the inventory on hand must be marked lower in order to be sold competitively, a loss is taken in that very process, a process that ends only in oblivion for many marginal concerns. That is how the level of wholesale commodity prices emphasizes the incapacities of operating managements. Businesses that are guided efficiently by skilled executive staffs, which keep liabilities, fixed assets, and inventories within reasonable bounds, take the rise and fall of prices in the same powerful stride. In occasional years, losses are assumed, but such concerns never become financially embarrassed.

LOSSES ON LOANS AND DISCOUNTS

In the past there may have been occasional years in the banking history of the United States in which no banking institution closed its doors or became financially involved. These years have been interspersed with others like 1837, 1893, and 1933, when hundreds of banks, through loose management, speculative investment policies, and the extension of unsound loans, have lost their stockholders money and were able to return to depositors only a portion of the funds entrusted to their care. Banking institutions have suffered over the years from incompetent and inexperienced managements, just as have commercial and industrial business enterprises.

In the critical years, substantial losses of commercial banks and trust companies have naturally been concentrated at two points: (1) losses on investments and (2) losses on loans and discounts. Both have been sources of fundamental trouble, but of the two, the amount of the losses on loans and discounts has been the greater.

Losses on loans and discounts may be broken down into three parts, as follows:

1. Losses on loans and discounts which had been granted only after thorough credit investigations and analyses.
2. Losses on loans and discounts which had been granted on inadequate credit information and analyses.
3. Losses on loans and discounts granted by high officials of banking institutions to personal friends, to concerns in which the officials might have had some near or distant personal interest, or to affiliated concerns of the bank itself.

Where Thorough Investigations and Analyses Are Made

Losses on loans and discounts granted only after what seemed to be thorough credit investigation and analysis would represent the normal losses and the normal risks of transacting a commercial banking business. Suppose, for example, a loan of \$200,000 had been extended, after a thorough investigation, to a well-established mill engaged in manufacturing woolen carpeting. The management had earned a reputation for manufacturing ability and had carried on operations successfully for fifteen years, but unfortunately, through a lack of vision, had failed to develop a product that could compete with woolen and synthetic materials. In this situation an operating loss was taken during the first six months of the year in which the loan of \$200,000 had been granted. Notwithstanding this fact, dividends were paid to stockholders before the management realized that the final yearly operating loss would be substantial. At the end of the year the loan extended by the bank had become frozen, and in the reorganization that ensued, the bank received \$.70 on the dollar for its claim. The banker who had granted the loan, not being in close touch with the manufacture of carpeting, had failed to realize the extent of the competition with new materials. He had also failed to examine the budgets of the mill during the early months of the year and to ascertain how actual operations were turning out in relation to budget forecasts. The profitable operations of the mill for fifteen years and the banker's personal high regard for the management had lulled him into a sense of complete security.

Where Inadequate Investigations and Analyses Are Made

On the other hand, losses on loans and discounts granted on inadequate information and analysis will always be large. The failure to ascertain that other banks are granting loans, possibly on a secured basis, that working capital is inadequate to pay trade bills promptly or by discount, that funds are being used to finance subsidiary or affiliated units, that accounts receivable contain a substantial amount of bad debts, will result only in greater losses and smaller profits to a bank. The only remedy is more training in the investigation and analysis of credit risks, in the realization that every avenue of pertinent information must be followed up, and in the study and interpretation of balance sheets, operating figures, surplus accounts, trial balances, and budgets. Conscientiousness will go a long way to overcome inexperience.

Where Borrower Is Closely Affiliated with Bank

Loans and discounts granted to business enterprises in which bank directors or officials have substantial interests, or to borrowers closely connected with the management of the bank, will always be a basic cause of some losses unless there is an earnest effort to investigate these loans with the same thoroughness to which other loan requests are subjected[2]

Every avenue of information must be explored with special care in the evaluation of credit risks of this character No borrower affiliated closely with a bank should be given more credit by that bank than he could obtain from any other well-managed bank with a sound loan program The gravest situation that can confront a bank is the use of its own money to excess by those closely connected with the bank or interested in it A request for a loan where social, personal, or other than strictly business considerations enter, also demand the most thorough study Loans to directors[3] of a bank or to concerns in which the officers or directors are financially interested should, therefore, be investigated and analyzed with even more than normal care, judiciousness, and conscientiousness

BANK SUSPENSIONS

Bank Holiday of 1933

On February 14 1933, the Governor of the State of Michigan declared a bank holiday, and Maryland followed on February 25 On the very same day Congress passed a joint resolution authorizing the Comptroller of the

[2] It is suggested that students of this subject read the records in connection with the closing of the Bank of the United States in New York City in December 1930 and also the comprehensive report of the Senate Committee on Banking and Currency on the *Investigation of Banking Operations and Practices* made pursuant to S Res 84, Seventy-second Congress and S Res 56 and 97, Seventy third Congress (Report No 1455, of the Seventy third Congress, Second Session, 1934) The investigations made following the closing of the Bank of the United States indicate the extent to which bank affiliates at times have made use of the funds of a banking institution to the ultimate loss of the bank, while the report of the Senate Committee on Banking and Currency analyzed other, somewhat less vulnerable, banking situations in New York City, Detroit, and Cleveland at the time of the banking moratorium

[3] The Banking Act of 1933 (Sec 12g) provides that no executive officer of any member bank shall borrow from or otherwise become indebted to any member bank of which he is an executive officer, and no member bank shall make any loan or extend credit in any other manner to any of its own executive officers The act further provides that, if any executive officer of any member bank borrows from or becomes indebted to any bank other than a member bank of which he is an executive officer, he must make a written report to the chairman of the board of directors of the member bank of which he is an executive officer, stating the date and amount of such loan or indebtedness, the security therefor, and the purpose for which the proceeds are to be used

Currency to exercise such powers over national banks in respective states as the state officials were exercising over state banks. On Saturday, March 4, the Governor of the State of New York proclaimed March 4 and March 6 bank holidays, and similar actions were then taken in other parts of the country. If banks outside of New York City could not draw upon their correspondents in the money center of the country, what chance did they have to remain open? Thus by March 4 the banks in most of the states were either closed or operating under restrictions. The entire situation was brought to a head on Monday, March 6, 1933, when the President proclaimed the national "bank holiday," under which banks were not permitted to pay their debts or to allow withdrawals during a specified period of time.[4]

Comparison of Bank Suspensions with Business Failures

During the years from 1898 to 1920 and from 1934 to 1958, the yearly percentages of the banking institutions suspended were appreciably smaller

[4] A philosophical sidelight to this interesting episode in our economic history is given by Thurman W. Arnold, *The Folklore of Capitalism* (New Haven: Yale University Press, 1937), pp. 142–3. "Late in 1932," he wrote, "I attended a conference in New York assembled by a gentleman of some prominence in the bank world, who foresaw in November the impending collapse of our banking system, which finally took place the next March. It was a small group of bankers, economists, and lawyers. The meeting was conducted in an atmosphere of intense gloom because everyone was convinced of two things: (1) that a collapse of the banking structure was imminent, and (2) that some drastic preventive measures were needed. On the question of the particular measures needed, no two men of the group agreed. Everyone saw dangers in everyone else's plans. The meeting ended in complete disagreement, as all meetings ended in those troubled times, no matter who attended them. Everyone, however, agreed with the statement of a prominent lawyer, who said, 'My mind fails to function when I think of the extent of the catastrophe that will follow when the Chase National Bank closes its doors.' I returned to New Haven much depressed and saw Professor Robinson, who remained quite unaccountably cheerful about the whole situation. I said: 'But you don't seem to realize that there is a crash coming.' He replied, 'Did any of these experts specify in any concrete terms what human beings would do when the crash occurred?' I admitted that they had not done so. He asked: 'Do you think that when the banks all close people will climb trees and throw coconuts at each other?' I admitted that this was a little unlikely but that a bank crash of this magnitude certainly sounded like rioting and perhaps like revolution. Professor Robinson replied: 'I will venture a prediction as to exactly what will happen. When the banks close, everyone will feel relieved. It will be a sort of national holiday. There will be general excitement and a feeling of great interest. Travel will not stop; hotels will not close; everyone will have a lot of fun, although they will not admit that it's fun at the time.' Months afterwards I happened to be in New York on the day that all the banks did close. I was amazed at the accuracy of Professor Robinson's diagnosis. I had very little cash but was able to give checks at hotels for food and lodging without any difficulty. Everyone was excited and interested. They had something to think about and talk about. It was a great emotional release. Space doesn't permit me to go into the reasons Professor Robinson gave for this guess. It was, however, among all the predictions which I heard about the impending crash, the only one that was accurate."

than the yearly percentages of commercial and industrial business failures. From 1921 through 1933, however, the tables were turned and the yearly percentages of bank failures were materially greater. The record of bank suspensions, moreover, is unusual in that, whenever an epidemic of chronic bank diseases has swept the land, the yearly percentage of suspended banking institutions has jumped up like a jack in the box, exceeding the maximum percentage of business failures in no small way.

For instance, in 1878, 1.55 per cent of all active industrial and commercial concerns failed, the largest percentage on record, as compared to 1.54 per cent in 1932. In 1933, however, 27.5 per cent of all banks had suspended, as compared to 7.6 per cent in 1932 and 6.7 per cent in 1893. These percentages compare rather poorly with the failures of business enterprises. The concentration in suspensions during periods of wild financial or economic gyrations has been prominent throughout our national economic history. Between 1930 and 1933 that concentration broke all known records. The climax was reached in 1933, with 4,004 suspensions involving deposits of $3,598,975,000, but only after 1931 and 1932 had already taken an immense toll of banking failures. The heightened effect of the epidemic that spanned these four years is clearly reflected in Figures 146 and 147.

In recent years bank suspensions have been rather nominal, decreasing rather steadily from fifty-nine in 1937 to one in 1944, 1947, and 1950, and none in 1945, 1946, and 1948. From 1941 through 1960 the yearly suspensions have represented less than one tenth of 1 per cent of the active banks. The aggregate deposits of suspended banks since 1935 have ranged from a high of $34,980,000 in 1939 to a low of none in 1945, 1946, and 1948. From 1941 through 1960 the aggregate deposits of suspended banks have represented less than one one hundredth of 1 per cent of the aggregate deposits of all banks.

In 1933, when 27.5 per cent of the banking institutions of the country had suspended, their deposits represented only 9.48 per cent of the deposits of all banks. A somewhat similar relationship (i.e., the percentage of deposits in suspended banks to all deposits was smaller than the percentage of the number of suspended banks to all banks) existed in each of the years from 1921 to 1945, covered in Figure 146, but the contrast is particularly evident in 1930, 1931, and 1932. In other words, the smaller banking institutions in the smaller cities and towns were apparently the more vulnerable. The fact that non member banks have been the more vulnerable is disclosed by the table of suspension in Figure 147, prepared annually by the Board of Governors of the Federal Reserve System, from 1934 through 1958.

In this table the number of bank suspensions and their aggregate deposits are classified as national and state banks that are members of the Federal Reserve System, and as insured and non-insured banks that are not mem-

Figure 146 Bank Suspensions and Their Deposits Compared with Number of All Active Banks and Their Aggregate Deposits (*1923–1960*)

	All Reporting Banks June 30, 1923-1937 Dec. 31, 1938-1960		Banks Suspended		Percentage Suspended to All Reporting Banks	
	Number	Deposits (000,000 omitted)	Number	Deposits (000 omitted)	Number	Deposits
1923. . . .	29,833	$ 40,688	646	$ 149,601	2.1	0.37
1924. . .	28,806	45,835	775	210,151	2.6	0.46
1925. . . .	28,257	49,224	618	167,555	2.1	0.34
1926. . . .	27,367	50,155	976	260,378	3.4	0.52
1927. . . .	26,416	52,909	669	199,329	2.5	0.38
1928. . . .	25,576	56,766	499	142,580	1.9	0.25
1929. . . .	25,110	53,852	659	230,643	2.6	0.43
1930. . . .	23,852	54,954	1,352	853,363	5.6	1.55
1931. . . .	21,903	51,782	2,294	1,690,669	10.5	3.27
1932. . . .	19,046	41,963	1,456	715,626	7.6	1.70
1933. . . .	14,519	37,998	4,004	3,598,975	27.5	9.48
1934. . . .	15,835	41,870	57	36,937	0.3	0.09
1935. . . .	15,994	45,766	34	10,015	0.2	0.02
1936. . . .	15,752	51,335	44	11,306	0.3	0.02
1937. . . .	15,527	53,287	59	19,723	0.4	0.04
1938. . . .	15,265	61,907	56	13,837	0.4	0.02
1939. . . .	15,096	68,566	42	34,980	0.3	0.05
1940. . . .	14,956	76,407	22	5,944	0.2	0.01
1941. . . .	14,885	82,233	8	3,723	*	**
1942. . . .	14,722	100,265	9	1,702	*	**
1943. . . .	14,621	118,336	4	6,300	*	**
1944. . . .	14,579	142,310	1	405	*	**
1945. . . .	14,598	166,530	None	—	—	—
1946. . .	14,633	156,801	None	—	—	—
1947. . . .	14,755	162,728	1	167	*	**
1948. . . .	14,735	162,041	None	—	—	—
1949. . . .	14,705	165,244	4	2,443	*	**
1950. . .	14,666	175,120	1	42	*	**
1951. . . .	14,636	186,603	3	3,113	*	**
1952. . . .	14,596	196,431	3	1,414	*	**
1953. . . .	14,538	201,978	4	44,412	*	0.02
1954. . . .	14,388	212,030	3	2,880	*	**
1955. . . .	14,265	221,391	4	6,498	*	**
1956. . . .	14,188	228,579	3	11,881	*	**
1957. . .	14,103	234,178	3	12,869	*	**
1958. . . .	14,034	251,331	8	6,287	*	**
1959. . . .	13,984	255,486	3	2,048	*	**
1960. . . .	13,971	266,884	2	7,987	*	**

* Less than 0.1 per cent.
** Less than 0.01 per cent.

bers of the Federal Reserve System. In 1934, 84.2 per cent of the suspended banks—that is, forty-eight out of fifty-seven—were non-insured, involving $34,985,000, or 94.8 per cent of the aggregate deposits of the suspended institutions. In 1945, 1946, and 1948 there were no bank suspensions. In

four of the years from 1947 to 1960, the number of insured banks that suspended exceeded the non-insured, in seven years the number of non-insured banks that suspended exceeded the insured, and in three years the numbers were identical

From 1934 to 1944 the concentration of bank suspensions was in insured non-member banks Of the 377 bank suspensions between 1934 and 1960, 233, or 61 8 per cent, were insured non-member institutions, 110, or 29 1 per cent, non-insured non-member, 27, or 7 per cent, national member, and 8, or 2 1 per cent, state member banks.

Figure 147 Bank Suspensions Classified as Members and Non-Members to the Federal Reserve System, and Insured and Not Insured (*1934–1960*)

Year ended Dec 3 —	Number					Deposits (in thousands of dollars)				
	All banks	Member banks		Nonmember banks		All banks	Member banks		Nonmember banks	
		National	State	Insured	Noninsured		National	State	Insured	Noninsured
1934	57	1		8	48	36 939	42		1 912	34 985
1935	34	4		22	8	10 101	5 399		3 763	939
1936	44	1		43	3	11 323	524		10 207	592
1937	58	3	2	47	6	16 169	5 025	1 708	19 156	483
1938	56	1	1	47	7	3 837	36	211	11 721	1 869
1939	42	4	3	25	10	34 985	1 323	24 629	6 589	2,439
1940	22	1		18	3	5 944	257		5 341	346
1941	8	4		3	1	3 723	3 141		503	79
1942	9			6	3	1 702			1 375	327
1943	4	2		2		6,309	5 0 7		1 241	
1944	1			1		405			405	
1945										
1946										
1947	1				1	167				167
1948										
1949	4				4	2 443				2 443
1950					1	42				42
1951	3				3	3 113				3 113
1952	3			2	1	414			1 279	135
1953	4			2	1	44,852		19 478	24 934	390
1954	3			1	2	2 880			936	1 950
1955	4	2		2		6 498	4 606		1 892	
1956	3			1	1	11 823	6 520		4 703	600
1957	3				3	12 869	10 451	1 163		1 255
1958	8	1		2	5	6,287	1 368		2 787	2 132
1959	3			3		2,648			2 648	
1960	2			1	1	7 987			6 953	1 034
Total	377	26	8	233	110	243 796	42 551	47 189	98 739	55 317

Fundamental Causes of Suspensions

A moderate percentage of all bank suspensions is caused by criminal actions, such as defalcations and fraud There is no doubt, however, that the fundamental causes over the years have been inefficient credit investigation and analysis, resulting in the extension of loans that subsequently become frozen, the attempt to earn an income above the market by the purchase of investments that yielded a return higher than the average, as already emphasized in this chapter, the extension of loans to officers and directors, to concerns in which the officers and directors had a direct financial interest, and to subsidiaries and affiliates of the bank itself, an inadequate knowledge of costs, too small a capital structure, and possibly, at times, the chartering of too many banks in a single community.

chapter XXIV

LIQUIDATION OF SLOW LOANS AND WORKOUTS

"If I had been a little less severe in my requirements in making loans during the first ten years of my banking experience, I could have made several thousands of dollars of additional income for my bank." The speaker was a western banker with forty-eight years of banking experience, who was reminiscing with half a dozen men who, like himself, had brought banking facilities to their respective communities in the early days of the wide open spaces. Those were the days when a tent, a kitchen table, an old grocery store safe, and a Winchester were standard equipment for the establishment of a bank.[1] This pioneer westerner had operated his bank conservatively from its opening day. Now, as he looked back over almost half a century, he felt that his loss ratio on loans had been too low during the early years of his experience. In order to bring that little bank through its first decade, he had had no scruples about declining loans, which he now felt he should have made.

Every banker who seeks to render the most complete and efficient service to his customers and to his community and who wishes to earn an adequate return for his stockholders must keep as large a percentage of his loanable funds at work as he reasonably and safely can. This natural policy implies the assumption only of those risks that experience and a thorough knowledge of credits dictate. It also implies the certainty that there will be some slow loans, some partial losses on loans, and some complete 100

[1] Often no state laws, reserves, or specialized banking knowledge circumscribed the promoter's activity. A strong physical constitution, courage, and instinctive conservativeness were the desirable, valuable attributes. In a country where men were pioneering, the demand for easy credit to be used for internal improvements and for speculation in new lands and new enterprises was in constant and relentless conflict with the demand for safe banking institutions.

per cent losses There will be some business enterprises to which loans will be made which will be overburdened with slow assets some will have large, high priced inventories in the face of declining commodity markets and others will become temporarily or permanently embarrassed because the active management has failed to anticipate changes in styles, habits, customs processes and politics These problems of operations were described and analyzed in Chapters XIII and XXIII

The "headaches" of business often require the commercial banker to discharge the functions of a doctor The banker must render all possible assistance to a distressed business so that the bank's loan will be wholly or partly repaid His stewardship of his depositors funds and of the investments of his own stockholders necessitates unremitting diligence He must if possible save an embarrassed business for its owners, its employees, and the community as well as for his bank If the concern is in generally sound financial condition with adequate reserves his task may not be difficult If, however the financial condition has been greatly weakened or if the management declines to take the steps that a thorough financial and industrial analysis indicates are absolutely essential to strengthen the business, his responsibilities may be exceedingly difficult to discharge

The day by day routine of making the majority of bank loans, especially during a period of prosperity may not seem to afford much excitement There is nothing dull however about a loan that has gone "sour" Although no banker anticipates any thrill in working out an involved business situation in which he has a slow loan and possibly a loss, such an experience may nevertheless call out the most constructive ingenuity he possesses It is one thing to conduct a banking relationship with a business enterprise operating smoothly and profitably it is quite another to conduct the same relationship with a concern that is making desperate efforts to keep afloat The financial difficulties of borrowers provide the banker with illuminating if harrowing experiences, but as a result of them, he is better able to counsel his customers in succeeding years and to assist them in avoiding unsound policies and practices.

At this point it may be well to point out that a good banker acts as financial consulant to his commercial customers even when they are not borrowing Frequently sound advice given before a difficult situation develops proves far more valuable than the granting of loans afterward It, therefore, behooves the banker to gain the confidence of his customers by encouraging frank discussions of financial statements during non borrowing periods At other times it may prove more helpful to the customer, his creditor, and the bank to refuse a loan when conditions show a

consistent decline, apparently due to mismanagement that ignores sound advice.

PROCEDURES FOR COLLECTING OVERDUE LOANS

When a borrower becomes unable to pay his loan at maturity, various courses of action are open to the banker. The borrower may be in temporary difficulty or he may be hopelessly insolvent. Between these two extremes there are obviously many different types of financial difficulty. If the borrower has merely experienced a temporary decline in sales, so that he is unable to retire a current loan, a simple extension of the obligation for a short period may provide the solution. Even when the extension operates for a year or two, no major problem may be involved, if the debtor is able gradually to retire his old debt, possibly with the aid of limited new loans for the current operation of the business.

If, however, the borrower's affairs have reached a hopeless condition and an extension of the obligation would be of no obvious help, then the banker may choose any one of five other procedures, graduating from persuasive to forceful action: a creditors' committee may be organized to oversee the operations of the business; a composition settlement may be offered and accepted; an assignment may be made for the benefit of all creditors; an equity receiver may be appointed; and finally the debtor may be adjudicated bankrupt. The remainder of this chapter will cover specific banking situations, in which each of these six steps has been taken to work out or to wind up the affairs of financially involved concerns.

Extensions

The least drastic method of handling the banking relationship with a concern that cannot meet its note at maturity is to grant an extension. If a thorough investigation indicates that the borrower is in fairly good financial condition and needs the funds because of somewhat enlarged activity or a slower season, the loan invariably is renewed. If, however, there are indications that its affairs are not in healthy shape, that additional investments in fixed assets have deprived the concern of adequate working capital, that losses have been assumed on inventories, that the receivables include substantial amounts of bad debts, or that excessive overhead has turned profitable operations into losses, then a decision must be carefully weighed as to what procedure would be the most expedient.

If the banker decides that adequate protection remains for his loan, that

a simple change in operating policy will correct the difficulty, or that he has a better chance of being fully repaid if he grants an extension on the outstanding loan, then he grants it the payment of the note is legally postponed to some future date This procedure is most favorable to the debtor He is granted whatever benefits may be obtained by the extra time without any sacrifice on his part Generally, although not always, extensions are granted where the financial condition of the business is obviously out of line, but appears to be remediable in reasonable time When a situation has not been worked out during the initial or supplementary extensions, other plans are followed leading in extreme cases to complete liquidation of the enterprise

Creditors Committee

When the problems of a distressed business may be successfully administered without resort to the courts—that is, when the financial condition is extended but not seriously impaired—and when there are several creditors with important amounts involved the creditors may appoint a committee from their number to oversee the operations of the business with co operation from the management In cases where several banking institutions are the primary creditors, they may at times find it desirable to advance the funds necessary to pay all trade obligations and to co operate with each other and the borrower to work out a solution Smaller committees are often able to operate more expeditiously than larger ones

Generally the chairman of the committee works in an intimate advisory capacity with the management, more closely than in the case of a simple extension Occasionally, if the management cannot be trusted to initiate and to carry out revamped operating policies some individual, either a member of the committee or someone outside it, may be placed in active charge of the business The organization, operating policies and management are changed to the extent necessary to correct those conditions that precipitated the difficulties Sometimes the changes are material involving the liquidation of subsidiaries and the sale of plants At other times adjustments are relatively minor, such as the institution of a less liberal credit policy and a more systematic collection procedure The creditors may arrange to extend old debts and advance new funds necessary for current operation If all debts are finally retired the business is returned to the owners If the situation does not work out so favorably, a receivership or bankruptcy might eventually be necessary The use of creditors' com

mittees has developed largely since World War I as a practical, inexpensive, and unofficial way of solving business difficulties.

Where two or more creditors agree among themselves and with the debtor to an extension, there is deemed to be adequate consideration to support the promise of each creditor. When such an agreement has finally been made, no one of those particular creditors has the legal right to demand payment before the expiration of the extended time without the consent of all the others and the debtor. No creditor can be compelled to sign, but the agreement is binding on all who do sign it. For this reason small creditors are often paid off in full to prevent bankruptcy proceedings by non-assenting creditors.

Little persuasion is needed to induce creditors to enter into extension agreements or to join a creditors' committee. Creditors, as well as bankers, are vitally interested in the solvency of their customers and their continuance in business. When a receivable has been considerably past due because of financial difficulties, the creditor has little to lose and much to gain by joining others in helping his customer. Undoubtedly his loss has been partially or entirely charged off and in any case, because the goods sold for more than they cost, it would not be as severe as the bank's loss; also, the amount creditors will receive in a forced liquidation is never certain.

To illustrate the functions of a creditors' committee: The Jaxon Jewelry Company, Inc., was established sixteen years ago. The concern had been organized to wholesale a general line of jewelry, watches, silverware, and diamonds, but gradually the field of activity was expanded to include the manufacture of fraternity jewelry, rings, and flat silverware. The principals, who devoted all their time to the business, were substantial stockholders. Through years of experience they seemed to be well qualified to handle their various departments economically.

In common with other dealers in luxury merchandise, the business was materially affected by a severe business recession. Not only did the volume of annual sales shrink, but it was becoming a difficult problem to collect the receivables from retail jewelry stores throughout the Middle West which likewise were feeling the effects of increased unemployment, wage cuts, and dividend reductions. The banks that shared the account had been liberal in extending credit. Quite suddenly they now found themselves in the position of having a badly frozen loan on their books. Everything considered, the immediate outlook for the enterprise was not at all optimistic. As the recession metamorphosed into a depression, sales continued to drop and operating losses brought on a situation that to some of

the creditors seemed to warrant only one course of action, the complete liquidation of the business. Creditors recognized that while there was a sizable amount of gold, silver, and platinum that could easily be realized, the major portion of the inventory was of a slow moving character, such as watches and manufactured jewelry.

The management evidenced every desire to co-operate and voluntarily curtailed withdrawals for salaries to an absolute minimum. They exerted their best efforts to make collections upon receivables. They also endeavored to reduce the inventory in line with the steady reduction in volume without sacrificing too much of intrinsic value. The employees accepted wage reductions without a murmur, and ultimately the management had to dispense with the services of those not vitally necessary to the continued operation of the business.

The banks had long since secured the guaranties of the principals on the loans of the concern. Finally, a meeting of creditors was held in the office of the primary bank creditor to decide upon a course of action. Twelve of the lesser creditors were disposed to force liquidation, since at the time there appeared to be no prospect of break-even operations and further losses would serve only to minimize the possibility of obtaining complete recovery of the advances. A creditors committee of seven members consisting of two bankers and five creditmen from merchandise suppliers, was organized in year E to consider and to decide upon a course of action. The banker with the largest amount at stake and with the most intimate knowledge of the situation ultimately prevailed upon the others to go along for one more year with the understanding that all creditors would be kept in close touch with the developments and that monthly figures would be submitted to them.

Figure 148 gives comparative balance sheets for an eight-year period set up as 100 per cent financial statements. This schedule shows a steady decrease in net working capital and net sales from year H through year E. Between these years the net working capital decreased from 49.98 to 41.86, and the net sales from 108.20 to 64.11, a noticeable and effective drop of 40 per cent. The financial condition of the enterprise was becoming more and more extended. During the same period merchandise showed a fairly steady increase as sales fell off, while current liabilities reflected some fluctuation, but with a general upward tendency. Operating losses were taken in each of these four years.

In year D a moderate change occurred, and in this year the extension agreement expired. A loss, but a smaller one, was sustained. At the same time a modest improvement was shown by the increase in the net working

capital from 41.86 to 45.05 and in the net sales from 64.11 to 81.61. The net sales were the greatest since year H. Moderate progress was being made. The plan of continuing, rather than liquidating, the business apparently was bearing fruit.

Another meeting of the creditors was then called. In view of the

Figure 148 Comparative 100 Per Cent Balance Sheets for the Jaxon Jewelry Company, Inc. (*years ended February 28, 19–*)

THE JAXON JEWELRY COMPANY, INC.
Comparative 100 Per Cent Balance Sheets for Years Ended February 28, 19__

	(H) 8 Years Ago	(G) 7 Years Ago	(F) 6 Years Ago	(E) 5 Years Ago	(D) 4 Years Ago	(C) 3 Years Ago	(B) 2 Years Ago	(A) 1 Year Ago
Assets								
Cash	4.28	3.17	2.28	3.14	3.81	5.21	4.35	5.75
Receivables	45.72	38.91	37.44	29.10	25.79	21.98	24.23	29.11
Merchandise . . .	42.62	47.52	45.79	52.80	54.52	56.60	56.74	52.62
Current Assets . .	92.62	89.60	85.51	85.04	84.12	83.79	85.32	87.48
Machinery.	4.84	5.97	8.42	11.60	12.58	12.80	11.33	9.85
Prepaid and Deferred Accounts. . .	.78	.61	.69	.58	.57	.57	.40	.26
Other Non-Current Assets. . . .	1.76	3.82	5.38	2.78	2.73	2.84	2.95	2.41
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Liabilities								
Due Banks.	23.96	23.40	31.95	28.30	20.91	13.61	13.25	10.61
Due Trade.	16.93	9.80	9.96	14.35	17.75	21.74	24.49	23.16
Taxes.	. . . .	. . . .	.13	.11	.18	. . . .	. . . .	2.38
Other Current Debts	1.75	6.58	.74	.42	.23	.32	.36	1.15
Current Liabilities .	42.64	39.78	42.78	43.18	39.07	35.67	38.10	37.30
6% Cum. Pref Stock	20.50	25.74	37.28	56.75	68.82	75.96	73.90	68.00
Common Stock . . .	20.85	26.74	38.73	58.96	71.51	78.90	76.77	70.65
Surplus	16.01	7.74	-18.79	-58.89	-79.40	-90.53	-88.77	-75.95
Total.	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Net Working Capital	49.98	49.82	42.73	41.86	45.05	48.12	47.22	50.18
Current Ratio . . .	2.17	2.25	2.00	1.97	2.15	2.35	2.24	2.34
Net Sales	108.20	74.94	66.67	64.11	81.61	109.54	132.44	164.00
Net Profit or Loss.	Loss	Loss	Loss	Loss	Loss	Loss	Loss	Profit

effective sales aggressiveness and the increase in net working capital, the creditors unanimously decided without a great deal of discussion that the same arrangement could be extended for another full year. Accordingly, the committee went to work to see if progress could be speeded up.

During year C the primary bank advanced a moderate amount of additional money on the assignment of current receivables, to enable the concern to take advantage of discounts in the purchase of merchandise.

The figures at the end of year C disclosed a further recovery Net sales had increased to 109 54, greater than for year H Net working capital continued on an upward trend current liabilities were reduced, and the net loss for the year was nominal The frozen condition of two years previously, when many of the smaller creditors had been anxious to liquidate the corporation, had gradually been turned into a fairly liquid condition The concern, however, was not entirely out of the woods and the creditors' committee continued to obtain monthly figures and to follow all operating policies

The figures for years B and A continued to disclose progress Every member of the creditors' committee endorsed the principal bank's program, and each year a formal extension was made of the remaining frozen indebtedness In year B net sales jumped to 132.44, double the sales for year E, when discouragement had been so rampant.

The figures for the end of year A showed the final recovery The largest net sales in the history of the business were handled, operations again were profitable, a fair net working capital had been built up, and a healthy trend in affairs was clearly evident The concern was now responsible for its reasonable credit requirements The creditors' committee was voluntarily discharged The confidence of the principal bank had been completely vindicated and the experience gained in weathering this particular financial storm undoubtedly would result in more careful operation by the management in the future Again everyone was happy— the owners of the business, the bankers, the merchandise suppliers, and the landlord

Composition Settlement

Occasionally a debtor realizes that his situation has become rather hopeless and opens negotiations with his creditors to pay them a percentage of his obligations, such as $ 30 $.60, or $ 80 on the dollar This percentage he wishes to be accepted as payment in full This procedure is known as a composition settlement. Such a settlement constitutes a discharge or release from obligations due to all agreeing creditors, not by the operations of the law, as in the case of bankruptcy compositions, but through mutual consent and consideration Common law compositions are more widely used in the cutting up divisions of the textile trade than in any other division of industry Negotiations leading up to a composition settlement are generally opened by the debtor, although occasionally the initiative is taken by a creditor

Obviously, where a thorough investigation indicates that a situation is hopeless, an extension of indebtedness would merely postpone more drastic action, and in the meantime, assets would be further dissipated. If real improvement cannot be made toward profitable operations, an extension of time would be basically unsound. There are naturally differences of opinion among creditors as to whether a situation is absolutely hopeless or not. Generally, however, the creditors who have the most at stake make the final decision as to what action will be taken.

Whenever a banker is confronted with a situation of this kind, there are several factors that he must carefully consider. Has every effort been made to obtain an accurate picture of the borrower's financial condition? Does the offer actually represent all the borrower can pay? Is the borrower honest and doing everything possible to discharge his obligation? In general, an honest offer of a composition settlement from a distressed concern may work out better for the banker and for the merchandise creditors than the complete liquidation of the business. Liquidation may mean the sale of the assets at considerable expense and at a greatly reduced price.

Before accepting any compromise settlement, the banker should first take the precaution of having the borrower sign both the financial statement submitted to substantiate the compromise and an agreement to reinstate the entire debt should later developments show additional assets not disclosed on the statement. The borrower should also present for evidence copies of his income tax returns for the previous three years.

A composition settlement is an agreement by creditors to accept a lesser amount in full settlement of their claims. Composition settlements are easily arranged and carried through if the bank is the only large creditor or one of a very few creditors who agree upon a definite program. If, however, there are a large number of creditors, several of whom are dissatisfied with the suggested settlement, who believe that a larger offer should be obtained, or who believe affairs could be worked out with some extension, the situation becomes more delicate and more difficult. A composition settlement is often effective without loss of time, inexpensive, and extremely practical for creditors as well as for the debtor.

Some composition settlements are made with cash payments in full and some with cash and notes, the notes generally maturing during the succeeding one to three years. Occasionally a concern is unable to meet its notes given in a composition settlement and becomes involved with creditors before the initial embarrassment has actually been worked out.

To illustrate a composition settlement: The Acron Company, Inc., had

been engaged in the manufacture of aluminum cooking equipment for eighteen years Operations had been uniformly successful until five years ago Then the demand for its products fell off The president and largest stockholder in the corporation, one Harold T Frank, at the time was well along in years He was highly regarded, and active in civic and philanthropic affairs in his community and had given large sums to local charities About three years ago Mr Frank became financially interested in a new side venture This venture developed into a complete failure Mr Frank had had such implicit confidence in the active management of this concern that he had borrowed $50 000 personally from his bank to provide working capital for it To secure this particular bank loan, he had pledged his entire common stockholdings in the Acron Company, Inc

In the meantime the affairs of the Acron Company, Inc, had also become somewhat involved as a result of substantial operating losses To make matters worse, the enterprise was no longer able to meet interest on a bond issue on its plant, and accumulated dividends on its preferred stock were three years in arrears The corporation had finally reached the point were money was required to meet payrolls and to make payments on past due merchandise bills At this point the report of the auditors and a study of the budgets prepared by the comptroller clearly showed that any new bank credit that might be extended could not possibly be repaid, unless there was a decided improvement in operating policies Moreover, the defaulted bond issue was a threat which might put the corporation out of business at any time If the concern went out of business, the loan the bank had made to the owner, secured by the corporation's common stock, would, of course, be absolutely worthless The entire situation looked about as dark and dismal as possible

What should the banker do in such a situation? Should he loan additional funds to the corporation and take the risk of a further loss, or should he allow the situation to run its natural course? In the latter event the bank would have a total loss on its loan At this stage the banker made a thorough personal analysis of the business There seemed to be little prospect of salvaging the loan first, because of the precarious state of the business itself, and, second, because the common stock that the bank held was junior not only to the defaulted bond issue but also to preferred stock on which dividends were in arrears, so that any ultimate value in the collateral appeared to be extremely doubtful

To protect the interest of his bank as long as possible, the banker suggested that a business consultant who had worked out several situations for the bank be elected to the board of directors The consultant was im-

mediately elected to the board. The new director then made a comprehensive, independent analysis of manufacturing operations and merchandising methods. As a result of his analysis, he offered a rather ingenious suggestion. In view of the splendid reputation of Mr. Frank in his community and the loyalty of his employees, he believed that most of the officers and some of the more important department heads might be willing to come to the rescue by using a part of their salaries to purchase some of Mr. Frank's stock at one half of the book value of the stock. If all of the stock held by the bank were taken on this basis, the bank would eventually obtain $.80 on the dollar for the loan, an acceptable compromise settlement. If carried out, this program would effect a gradual reduction, if the loan could be extended over a period of two or possibly three years. The matter was placed before all the employees by the president, and 105 employees agreed to participate in purchasing the common stock at this figure.

The banker then proceeded to loan the corporation a modest amount of new money for current working needs, secured by the assignment of receivables. The new stockholders now had a vital interest in the success of the enterprise. They were all on the job, whereas Mr. Frank had drawn a substantial salary and had given a small portion of his time to the business. Sales began to expand, the machinery began to hum more steadily, and within eighteen months the affairs of the corporation began to show a definite improvement, and the loan for current working needs was retired. As a result of the arrangement made for the sale of the president's common stock to his associates and employees, the bank received a check every month on account of the president's loan. Within three years the $40,000 was obtained in full payment of the $50,000 loan with interest—the 80 per cent settlement agreed upon; a successful business was on its feet running overtime; and in place of an impaired loan, the bank had a desirable account on its books with the highest regard for the new owners. The composition settlement obtained in this case through the medium of the new common stockholders was the only alternate to a complete write-off on the loan, and the day was saved.

Assignment for the Benefit of Creditors

A debtor who is quite involved financially may be unwilling or unable to arrange an extension or a composition settlement with his creditors. Under these circumstances his creditors may institute legal proceedings to enforce payment of their claims. If the debtor realizes the precarious-

ness of his situation, he may select the procedure under which his business will be liquidated before creditors force action. In this predicament he may make an assignment—that is, a voluntary transfer in trust—of his assets for the benefit of all of his creditors. The assignee must collect, preserve, and distribute the assets for the benefit of the creditors without preference, except such as may be prescribed by law or by the instrument of assignment. Such an assignment is an act of bankruptcy and may be the debtor's method of bringing about a petition in bankruptcy without filing such a petition personally. Many assignments are made to creditmen's associations, trade associations, adjustment bureaus, lawyers, and friends.

The assignee is thus chosen by the debtor, and his task is to administer the property for the benefit of all the creditors. He may, at the discretion of the creditors, continue the business, awaiting a better time to sell the property and to distribute the proceeds. This method of handling a distressed business enterprise has its disadvantages, since the debtor is permitted to select the person to administer his assets. Furthermore, an assignment often leads to bankruptcy proceedings. Moreover, a receivership may accomplish substantially the same objective under the supervision of a court. An assignment, however, may under favorable circumstances be less expensive, since court costs, attorneys' fees, and the fees of officials provided for in the Bankruptcy Act are reduced or eliminated. An assignment operates more rapidly, works without restraint from a court, and may function privately. As a result better prices may often be obtained because of speed in making decisions. An assignment, moreover, is presumed to give creditors confidence in the good faith of the debtor who has been unable to operate his business successfully, and to provide an economical means, not subject to such strict legal supervision as bankruptcy proceedings, of converting assets into cash and of distributing the cash pro rata to creditors. If, however, a statutory assignment is made, these advantages are not entirely realized.

There are, however, a number of limitations to liquidation through assignment. In the first place, such an assignment constitutes an act of bankruptcy. Consequently, nonassenting creditors, by initiating bankruptcy proceedings, may take the administration of the estate out of the jurisdiction of creditors or the state insolvency court, since bankruptcy supersedes all other forms of liquidation of insolvents. Second, there is no power under friendly assignments to subject the debtor to an examination under oath. Third, there is no machinery for the recovery of preferential payments. Fourth, from the debtor's point of view, the chief objection is that he cannot secure a discharge from his obligations except by the consent of all creditors. Fifth, there is the territorial limitation, since assignments are governed by different laws under varying

jurisdictions. Especially is this true of statutory assignments. Sixth, there is lack of uniformity in the laws and requirements of the various states. Finally, there is no direct effective supervision over the assignee in the administration of the estate. Debtors have the power to appoint their own assignees and in some states they are not compelled even to consult the creditors or to obtain their consent to the appointment. This objection, however, is largely theoretical, since the assignment, while presumably voluntary, is made under the pressure of creditors who are in a position to dictate terms.[2]

To illustrate an assignment: About twenty-two years ago John Doran and Henry Thomas started a men's furnishing store in a city of one hundred thousand people in the State of Pennsylvania with an original investment of $6,000. Two years later the partnership acquired business premises on a prominent corner. This property subsequently increased in value and after ten years was sold at a price to yield a clear profit of $85,000. The inventory and the other assets were sold at the same time for a cash consideration of $12,000, and the partnership ended. Shortly afterward, the two men formed the Doran and Thomas Wholesale Dry Goods Company, Inc. That took place a little over nine years ago. The authorized and paid-in capital was $150,000, all cash.

Comparative figures are shown for five individual years, covering a ten-year period, in Figure 149. The first loan made by the bank to the new enterprise was made on January 28, year J, for $1,000. This loan was increased from time to time during the remainder of the year and, as of December 31, stood at the respectable sum of $97,500. The balance sheet at this date showed total current assets of $275,373, well over current liabilities of $143,732. Net sales for the year amounted to $471,217, on which a net profit of $55.69 was realized. A considerable portion of the expenses incurred in the organization of the corporation were paid out of the earnings, so that operations for the year were quite satisfactory.

The corporation continued to expand its business during the following year, and high credit extended by the bank reached $118,500 unsecured, and $13,621 represented by notes receivable discounted. Liabilities to the bank were reduced to $25,000 during the early summer, but at no time during the year was the concern clear with its bank. Operations during this year continued to be profitable. Capital stock paid in was increased to $170,000. About this time the concern also arranged for a line of credit with a second bank and at the end of year H, eight years ago, reported

[2] Theodore N. Beckman, and Robert Bartels, *Credits and Collections in Theory and Practice* (6th ed.; New York: McGraw-Hill Book Company, Inc., 1955), pp. 487–8.

notes payable to banks of $124,000 Of this amount, $104,000 was due to one institution and $20 000 to the other

After three years, in year G, the management had demonstrated its ability to increase sales to a high figure of $895,617, with a resultant extraordinary net profit of $57,184 Cash dividends of $17,000 represent

Figure 149 Comparative Balance Sheet for Doran and Thomas Wholesale Dry Goods Company, Inc (*years ended December 31, 19—*)

DORAN AND THOMAS WHOLESALE DRY GOODS COMPANY INC

Comparative Balance Sheet for Years Ended December 31 19__

	(J) 10 Years Ago	(G) 7 Years Ago	(E) 5 Years Ago	(C) 3 Years Ago	(A) Last Report
Assets					
Cash	$ 1 338	$ 13 419	$ 3 366	$ 9 286	$ 1 882
Accts Receivable less Reserve	100 989	195 028	76 142	73 946	50 117
Notes Receivable	4 618	2 638	13 804	4 280	
Merchandise Inventory	168 429	208 133	174 186	125 038	65 038
Current Assets	$275 373	$419 218	$267 498	$212 550	$117 037
Past Due Accounts					2 308
Advances to Salesmen	395	51	53	6 132	9 145
Claims	827	557	852	300	305
Real Estate			10 989	10 989	6 000
Furniture and Fixtures Net	8 052	8 237	8 391	5 550	3 749
Deferred Charges	9 140	8 906	9 076	8 973	716
Total	$293 787	$436 969	$296 859	$244 494	$139 260
Liabilities					
Notes Payable to Banks	$ 97 500	$105 000	$ 90 030	$ 85 000	$ 29 500
Accounts Payable Trade	44 904	108 378	16 164	26 994	31 040
Accounts Payable Other	1 328	1 135	250		1 350
Current Liabilities	$143 732	$214 513	$106 414	$111 994	$ 61 890
Common Stock	150 000	170 000	169 500	169 300	169 300
Surplus	55	52 456	20 945	36 800 D	91 930D
Total	$293 787	$436 969	$296 859	$244 494	$139 260
Net Working Capital	$131 641	$204 705	$161 084	$100 556	$ 55 147
Current Ratio	1 92	1 95	2 51	1 90	1 89
Tangible Net Worth	$150 055	$222 456	$190 445	$132 500	$ 77 370
Net Sales	$471 217	$895 617	$436 253	$355 854	$217 168
Net Profits	55	57 184	23 258 L	32 184 L	30 335L
Dividends		17 000	None	None	None

ing 10 per cent on the outstanding stock, were paid The balance sheet at the close of this year disclosed notes payable to banks of $105,000, of which $85,000 was due to the principal depository and $20 000 to the other The low debt to banks during this year was $20 000

The balance sheet for the next year is not shown, but there were signs of a reversal in the trend of affairs Net sales were off somewhat to $721, 304, on which a net profit of only $8,791 was recorded A cash divi

dend of $17,000 was paid, causing a modest reduction in the tangible net worth. At the end of the year the concern was owing one bank $80,000 and the other $30,000.

The figures for year E continued to reflect a contraction in operations. The sales decreased substantially to $436,253, on which a net operating loss of $23,258 was shown. At the close of the year, bank borrowings of $90,000 were confined to one bank. After submitting its figures, the management was called in by the principal banker for a discussion of the condition of the business and its outlook. In view of the substantial operating loss, the management agreed that overhead expenses should be drastically cut. Liabilities had been reduced from $214,513 to $106,414 between years G and E, but there were ominous clouds on the horizon. The downward trend and unprofitable operations continued. The twelve months ending December 31, year D, were even more unfavorable from an operating standpoint than the preceding years. Sales of $359,730 showed a contraction, and there was a net operating loss of $25,559.

When this business was established, the locality was on the eve of the biggest boom it had ever experienced. The peak of the boom was reached about three years after the inception of the corporation. A recession then set in that carried the locality through bad times which lasted several years, even though other sections of the country were enjoying prosperity. By year D a defeatist attitude prevailed. The officers co-operated in attempting to curtail expenses, but the net sales were dropping faster than expenses could be cut. The indebtedness to the principal bank at the end of year D was $76,500, and to the other, $15,000.

Without a doubt year C was the most disappointing period experienced by businessmen in this particular locality. Sales continued to spiral downward, and collections became slower and slower. The operating results showed a net loss of $32,184 for the year. The indebtedness to the principal bank had been reduced to $65,000, and $20,000 was owing to the second. The balance sheet now showed a deficit in the surplus account of $36,800—not an attractive picture in contrast to an actual surplus of $52,456 at the end of year G, four years earlier.

Sales for year B, two years ago, were even lower, and operations disclosed a loss of $27,064. With no change in the trend of affairs, the principal banker called a conference with the management and expressed a desire that policies be immediately instituted to reduce expenses even more radically. One of the suggestions called for the resignation of a vice-president drawing $8,000 in salary and making no real contribution to the management. The concern was also advised that the bank debt should

be put on an orderly program of liquidation, and a preference was expressed for monthly amortization At the end of the year all of the bank debt, $42,500 was due to the one primary bank.

The operating statement for year A reflected a further decrease of approximately 30 per cent in sales—the lowest sales in its history, even below the volume transacted during the first year of operation—with a loss of $30 335 after the elimination of certain worthless receivables Over a five year period operating losses had aggregated $112,875 The tangible net worth had shrunk from $190,445 to $77,370, or 60 per cent. The balance sheet showed a surplus deficit of $91 930, with indebtedness to the local bank of $29 500 Needless to say, the bank officers were much concerned over the collectibility of the remainder of the loan.

After carefully reviewing the situation, both the management and the bank officials decided that the business should be liquidated With the borrower s co-operation, a plan was effected for the voluntary assignment of the assets for the benefit of all creditors The first step was for the corporation to make the assignment in writing the assignment contained a list in the form of one schedule showing the property transferred in trust, the disposition to be made of each asset, and a list of all of the creditors for whose benefit the assets were being assigned The following steps were then taken

1 The assignment was executed by the assignor (in some states it must also be executed by the assignee)

2 The instrument was recorded (where necessary) to make it valid.

3 The assignment was delivered to the assignee Failure to do so may render the act void and fraudulent against judgment creditors

4 Possession of property was delivered to the assignee

The assignee with the co-operation of the management then proceeded to convert the assets into cash over a period of seven months. Expenses incident to the execution of the trust were deducted, and the funds left over were distributed pro rata to creditors. When the liquidation had been completed, the bank s loss on the $29 500 owed by the borrower was $4,740 The stockholders were completely wiped out.

Equity Receivership

The creditors of a financially embarrassed concern may decline to grant an extension of its obligations A composition settlement may not be necessary if the assets are adequate to meet liabilities, and the debtor may not wish to make an assignment. In that event one or more creditors may

request a court to appoint an equity receiver to take charge of the property subject to the control of the court. The receiver may continue the business under authorization of the court until a plan of settlement or reorganization is worked out or until, as often happens, the concern is adjudicated bankrupt.

An equity receivership is occasionally sought for an insolvent debtor, but more generally for a debtor who

is solvent in the bankruptcy sense but is unable to meet his obligations as they mature. The object of a receivership is to preserve the estate during the readjustment, reorganization, or litigation which is to decide the rights of the litigants, and to establish a so-called "moratorium" on behalf of the debtor. To warrant the appointment of such a receiver, the court must be shown by the plaintiff that such action is necessary to prevent loss or injury to those financially interested. A mere default in payment of an obligation is not sufficient ground, for under such circumstances the ordinary processes of the law can be resorted to as a remedy.[3]

By this process, legal protection is given both creditors and debtor. Like an extension, an equity receivership defers the date of payment of obligations, not, however, for a stipulated period, but at the discretion of the court. The receiver, as an officer of the appointing court, is a disinterested party who takes charge of and administers the property placed in his care. At all times he is under the direction and the order of the court that appointed him. Often he continues a business enterprise with the close co-operation of a creditors' committee. When the business has been rehabilitated or liquidated, the receivership is terminated by the discharge of the receiver by the court. Operations under a receivership are often expensive from both a monetary and a good-will point of view.

To illustrate an equity receivership: The Mason Grocery Co., Inc., was established in 1893 in Elston, a small southern city in an agricultural community. In 1901 the business was incorporated with a paid-in capital of $75,000. From time to time branches were placed in other towns in that territory, and in 1905 its principal office was moved to Oldham, a more centrally located city near by. Operations were uniformly successful for many years, the business growing until a paid-in capital of $750,000 and a surplus of $850,000 had been attained.

At the time under consideration, the banking of the corporation was divided among the Oldham National Bank and two neighboring institutions. Although no set lines of credit had been agreed upon by any of the three banks, unsecured credit to a total of $300,000 was at its disposal

[3] *Ibid.*, p. 491.

from these sources The Oldham National Bank loaned as high as $150,000, one of the other banks, up to $100,000, and the third bank, $50,000 Two of the larger stockholders had also made rather liberal advances of credit as needed In addition, commercial paper had been sold in the open market In this way the lines at the three banks were cleared from time to time Periodical checkings made through trade sources brought replies of a most complimentary nature Satisfactory balances were maintained at each of the interested banks

The management was ambitious and, shortly before the time under consideration, had initiated an expansion program A canning factory was established, a coffee roasting plant was installed, and various products were placed on the market under the concern's distinct brand names By year J (page 619), ten years ago, twelve branches were in operation, and the concern owned the real estate and the building in which the branch was located A fleet of trucks was maintained for transportation purposes, and a garage had been established to service the trucks All these activities tended to place more and more of the capital in fixed assets and to reduce the net working capital Moreover, a rather liberal credit policy was being pursued, and the receivables were somewhat heavy, but all in all, the figures for year J disclosed a healthy margin of protection (see Figure 150)

The condensed balance sheet, as of May 31, year H, reflected a substantial increase in the liabilities during the two-year period, from $625,559 to $851,092, and a somewhat smaller reduction in the net working capital A number of unfavorable trends now became evident The investment in real estate, buildings, machinery, and equipment had increased Excessive dividends had been paid out during the preceding two years, bringing about a reduction of $35,693 in the surplus The liberal credit policy had been continued, reflecting an average collection period of forty two days, whereas competing concerns were showing thirty-two days About this time the receivables were carefully examined by an officer of the Oldham National Bank and revealed a considerable amount past due and a liberal sprinkling of questionable notes and accounts Real estate holdings also were examined and showed a sizable amount of real estate for which the corporation had no actual use

As a result of these factors, a program of retrenchment was advised by the banker, a program to which the management readily agreed A more prompt collection of receivables was to be emphasized, and an effort was to be made to reduce real estate holdings A study of the situation revealed that the principal causes of the unfavorable trend in the financial

condition, notwithstanding profitable operations, were (1) the ambitious expansion program of the management, (2) the increase in investment in fixed assets, and (3) the liberal credit policy.

The attitude of the Oldham National Bank, as well as that of the other two interested banks, was friendly at all times. Many conferences were

Figure 150 Comparative Condensed Balance Sheets for Mason Grocery Co., Inc. (*years ended as shown*)

	(J) 10 Years Ago May 31	(H) 8 Years Ago May 31	(F) 6 Years Ago Dec. 31	(D) 4 Years Ago Dec. 31	(C) 3 Years Ago Dec. 31	(A) Last Report May 31
Assets						
Cash	$ 120,666	$ 106,134	$ 38,889	$ 13,184	$ 25,470	$ 42,551
Receivables	681,800	652,024	478,784	215,727	147,919	237,262
Inventory	858,675	1,010,446	453,991	356,810	422,264	445,840
Other Current Assets	...	...	33,425	21,534	...	...
Current Assets	$1,661,141	$1,768,604	$1,005,089	$ 607,255	$ 595,653	$ 725,653
Real Estate, Buildings, Machinery and Equipment	564,677	626,793	802,756	665,351	562,081	516,254
Due from Officers and Stockholders	...	...	31,118	106,013	6,089	4,161
Other Assets	...	20,261	64,285	65,276	57,699	36,552
Total	$2,225,818	$2,415,658	$1,903,248	$1,443,895	$1,221,522	$1,282,620
Liabilities						
Notes Payable, Banks	$ 303,000	$ 300,000	$ 288,250	$ 218,750	$ 193,488	$ 145,000
Commercial Paper Outstanding	...	300,000	...	...	...	...
Accounts Payable	91,543	89,063	79,708	131,432	126,553	95,411
Due Stockholders	231,016	162,029	44,375	24,829	37,474	52,542
Current Maturity on Industrial Loan	...	...	...	...	...	20,000
Current Liabilities	$ 625,559	$ 851,092	$ 412,333	$ 375,011	$ 357,515	$ 312,953
Due on Real Estate	...	...	...	...	...	2,083
Due on Industrial Loan	...	...	...	...	...	90,000
Due Stockholders, Deferred	...	...	...	...	...	40,000
Total Liabilities	$ 625,559	$ 851,092	$ 412,333	$ 375,011	$ 357,515	$ 445,036
Common Stock	750,000	750,000	750,000	750,000	746,000	747,900
Surplus	850,259	814,566	740,915	318,884	118,007	89,684
Total	$2,225,818	$2,415,658	$1,903,248	$1,443,895	$1,221,522	$1,282,620
Net Working Capital	$1,035,582	$ 917,512	$ 592,756	$ 232,244	$ 238,138	$ 412,700
Current Ratio	2.66	2.08	2.44	1.62	1.7	2.32
Tangible Net Worth	$1,600,259	$1,564,566	$1,490,915	$1,068,884	$ 864,007	$ 837,584
Net Sales	$5,692,140	$5,697,682	$3,156,487	$2,067,000	$2,295,071	$3,223,880
Net Profits	65,606	43,830 (L)	1,264 (L)	37,521	20,466	34,259
Dividends	37,500	45,000	93,500	None	None	None

held between the officers of the business and the bankers for the purpose of assisting them in solving their problems; and while the management had admittedly made a number of mistakes, the concern still enjoyed the confidence of the banks and of the trade. As of May 31, year H, the indebtedness to the banks amounted to $300,000. At the same time the concern had

outstanding an equal amount of commercial paper which had been sold in the open market This was an elementary mistake in financial management, as commercial paper should never have been sold so that the total borrowings were in excess of confirmed open bank lines The concern also owed $162,029 to stockholders In the fall of year H, the management started to make an earnest effort to correct these unfavorable features Much was accomplished in their efforts to liquidate doubtful receivables, but much less in disposing of excess real estate Also, from time to time unprofitable branches were eliminated

In the following year, the concern could no longer sell commercial paper in the open market, and the banks temporarily increased their loans to help retire these notes as they matured The program of retrenchment continued and, by December 31, year F, all of the open market paper had been retired, and the total debt to banks had been reduced to $288,250 By this time the loans held by the banks were regarded as frozen, and no further liquidation appeared possible if the business was to continue As a matter of fact, stocks of merchandise had been depleted in the program of liquidation, until it became rather difficult to transact business in an orderly way, the inventory between year H and year F having dropped from $1,010,446 to $453,991

In July, year F, an appraisal of the properties had been made by engineers, and appreciation in the amount of approximately $206,000 had been added to fixed assets and a corresponding amount to surplus The fixed assets were now carried at $802,756, as compared to $626,793 on May 31, year H The management hoped in this way to improve its financial statement and bolster the credit of the corporation This policy, of course, was a second mistake, just as elementary as selling commercial paper in addition to the full use of its bank lines

Net sales were now declining drastically For the twelve months ending year F, net sales amounted to $3,156,487, a decline of 45 per cent as compared to net sales for the year ending May 31, year H At the end of year F, a dividend of $93,500 was paid without consulting the banks, for which the management was criticized severely Here was a third elementary mistake This money was needed badly in the business The concern's problem had now become serious At the end of year F, the bank debt, which amounted to $288,250, was in a precarious position, and real concern was felt for the future of the business The bank debt now was definitely a capital loan

In year E, five years ago, the credit agencies reduced their ratings and early in year D withdrew their classifications of the risk altogether Sev-

eral applications to the banks were made for additional loans, all of which were declined. However, from time to time, the banks advised with the officers regarding their problems and suggested various ways of converting unproductive assets into cash.

In the summer of year D, the management, after consulting with the banks, filed a bill in equity and had a receiver appointed, turning over possession of the business to him. It had developed that the officers and employees had been borrowing in rather large amounts from the company, a fourth elementary mistake. This was shown by the increase in the item "Due from Officers and Stockholders" from $31,118 to $106,013 between years F and D. This practice the receiver immediately stopped. Following the advice of the banks, several new policies were now put into effect as follows:

1. An effort was made to collect or secure the indebtedness due to the corporation from the officers and the employees.

2. A study was made to determine what lines of merchandise and what branches were unprofitable.

3. An effort was made to determine the actual value of the assets and to write them down to their proper values.

4. A more determined attempt was made to improve the condition of the receivables.

5. A general reduction was made in operating costs. In addition, a new treasurer was chosen.

In the autumn of year D, with a slight improvement in business, the banks loaned the company an additional $100,000, secured by a pledge of accounts receivable. The loan was made for the purpose of enabling the corporation to replenish its badly depleted stocks of merchandise. This loan, in which the three banks participated, was repaid at its maturity in the following spring.

As is indicated by the condensed balance sheet, as of December 31, year D, affairs were in a serious condition. A substantial loss in operations was taken. The management had become somewhat discouraged and was not in full accord with the bankers regarding the solution of the problems presented by the condition of the business. The president's health had become very bad, which further complicated the problems. For several years his life had been insured for $150,000. The president had become indebted to the company for approximately $100,000, and, because of his seriously involved personal financial condition, the debt was of doubtful value. The life insurance was kept in force and was assigned to the corporation, although $21,000 had been borrowed on the policy during year

D The president died early in year C The insurance was immediately collected, and the indebtedness of the president to the corporation was eliminated, thereby substantially reducing the amount due from officers and employees and supplying badly needed cash to the business

The receiver now undertook the task of re establishing the enterprise A careful appraisal of all assets was made to determine their actual values, and immediately the work of writing down the values to reasonable figures was begun By this time the branches had been reduced to four in number, thus leaving several pieces of unused real estate to be sold Emphasis was placed upon the sale of unnecessary physical properties, and some cash was realized in this process A careful study of all departments was made in order to eliminate the practices that were causing operating losses Some unprofitable departments were eliminated entirely, as well as a number of unprofitable lines of merchandise The entire personnel was reorganized, and several unproductive members of the staff were eliminated Particular attention was given to the sales force, which was completely reorganized The transportation problems of the business were carefully studied, and the number of trucks was reduced, resulting in a substantial saving All items of expense were thoroughly analyzed, and many adjustments were made

As shown in the condensed balance sheet, by December 31, year C, the net working capital had been greatly reduced, so that the business was confronted with the problem of obtaining current funds with which to continue operations With this in mind, the management made application to a Federal agency for an industrial loan of $150,000, to be secured by a mortgage on physical properties After lengthy negotiations this loan was obtained, and the funds were available shortly after the close of year C The loan was payable $20,000 annually for four years, and a year after that the balance of $70,000 would become due In this manner the fixed assets were used to supply working capital This money, together with the funds received from the insurance carried on the life of the president, greatly relieved the pressing need for working capital. At this time, payments were made to each of the bank creditors, which materially improved the status of these obligations Operations continued at a loss for over a year, but gradually the revamped policies began to show results, and figures once more reflected profits

In the balance sheet as of May 31, year A, the current ratio was 2 32, and the industrial loan had been reduced to $110,000 $20,000 carried as a current liability and $90,000 as a deferred liability Profits for the year ending May 31 were in excess of $34,000 The banks now felt that the

condition of the loan was satisfactory. The concern was enjoying a volume of business approximately 16 per cent over the same months of the previous year, and estimates indicated that at the end of the current fiscal year a substantial amount would be added to the surplus account. With the agreement of all of the creditors, the receivership was terminated, and the control of the corporation was returned to the management.

To summarize, here was a long-established business whose condition had become precarious, because of laxness on the part of the management, liberal credit policies, and an overly ambitious program of expansion. Prior to year D, the figures had not been audited. Not only the banks but the trade creditors also had implicit confidence in those in charge of its affairs and had not insisted upon annual audits. If such audits had been available, the practices that had led to the difficulties would undoubtedly have been brought to the attention of the banks sooner, and corrective measures might have been applied at an earlier date. The situation, however, was finally corrected by the receiver who had carefully analyzed the problems and then taken the necessary steps to re-establish the business as a profitable enterprise.

Bankruptcy[4]

Congress is authorized by Article I, Section 8 of the Constitution to establish uniform laws on the subject of bankruptcy.[5] James Madison, writing in *The Federalist*, defended this provision of the Constitution by asserting that:

The power of establishing uniform laws of bankruptcy is so intimately connected with the regulation of commerce and will prevent so many frauds where

[4] The authors are indebted to George A. Hansen, attorney, Law Department, The First National Bank of Chicago, for this section on bankruptcy.

[5] Several sources present a comprehensive treatment of bankruptcy problems. Two complete treatises are: "Collier on Bankruptcy" nine volumes, 14th Edition, James William Moore, Editor-in-Chief, supplemented in 1960, publisher Matthew Bender & Company, Inc., 225 Orange Street, Albany 1, New York and 205 East 42nd Street, New York 17, New York; and "Remington on Bankruptcy" fourteen volumes, Fifth and Sixth Editions and now receiving 1961 revisions. Fifth and Sixth Editions by James M. Henderson, 1961 revision by Kenneth H. Hayes, Publisher, The Lawyers Co-Operative Publishing Company, Rochester, New York; others are: Collier Pamphlet Edition Bankruptcy Act (479 pages) 1960 Edition by William T. Laube (usually referred to as Collier Bankruptcy Manual); and "The Law of Bankruptcy," Charles Elihu Nadler, 1948 Edition, publisher, Callaghan & Company, Chicago, Illinois. An excellent shorter booklet on bankruptcy is: "Bankruptcy and Arrangement Proceedings," John E. Mulder and Leon S. Forman, published by Committee on Continuing Legal Education of the American Law Institute collaborating with the American Bar Association. Director's address: 133 South 36th Street, Philadelphia 4, Pennsylvania.

the parties or their property may lie or be removed into the different states, that the expediency of it seems not likely to be drawn into question.

Because the creditors of the early bankrupts were usually located within the limits of a single state, with the exceptions of temporary Federal bankruptcy laws of 1800, 1841, and 1867 passed by Congress to ease recovery after early depressions, bankruptcies were covered by a variety of state laws As the unit of the business enterprise grew in size, influence, and power, with assets as well as creditors located in many states, a single Federal law became imperative and was finally passed by Congress in 1898, superseding all of the separate state bankruptcy laws Seventeen years of intensive debate preceded the passage of the Act of 1898, which is generally regarded as the cornerstone of modern United States bankruptcy legislation

Many amendments to the Bankruptcy Act of 1898 were passed in subsequent years, but the most complete revision occurred in 1938 and became commonly known as the Chandler Act The Chandler Act extensively changed the procedures in ordinary bankruptcy or liquidation and rewrote much of the emergency bankruptcy provisions passed in the early years of the Depression Several amendments have been enacted in the years following the passage of the Chandler Act, including changes in rules on priorities, procedures, and constructions The statute is not constant, and fairly frequent amendments altering particular procedures are to be expected Under the present act, the following are covered Chapters I to VII, Ordinary Bankruptcy, Chapter VIII, Agricultural Compositions and Extensions, Chapter IX, Composition of Indebtedness of Certain Taxing Agencies or Instrumentalities, Chapter X, Corporate Reorganizations, Chapter XI, Arrangements, Chapter XII, Real Property Arrangements by Persons Other Than Corporations, and Chapter XIII, Wage Earners' Plans

Ordinary Bankruptcy (Chapters I–VII) Proceedings under chapters I to VII of the Bankruptcy Act may be (1) voluntary, as, for instance, when a debtor asks to be adjudged bankrupt, or (2) involuntary, when the creditors ask that a debtor be adjudged bankrupt. In a voluntary proceeding insolvency need not be alleged or proved, the essential requirement being that the petitioner have "debts" With certain exceptions, any person or business concern having debts of $1,000 or more may be adjudged an involuntary bankrupt on the petition of three or more creditors whose claims amount to $500 or more, or if the creditors number less than twelve, one creditor with a claim of $500 or more may file such a petition

In an involuntary bankruptcy the petition must allege that the debtor has within four months next preceding the filing of the petition committed one or more acts of bankruptcy. The statute sets out six acts of bankruptcy. They are, in general terms: (1) a fraudulent conveyance or concealment of assets; (2) the transfer while insolvent of any portion of the property to one or more creditors with an intent to prefer the transferee; (3) a lien upon any of the debtor's property through legal proceedings that are not vacated or discharged at least five days before the date set for sale or other disposition of the property; (4) a general assignment for the benefit of creditors; (5) appointment of a receiver or trustee to take charge of the debtor's property while he is insolvent; and (6) the admission in writing by the debtor of his inability to pay his debts and his willingness to be adjudged a bankrupt. The alleged bankrupt is then served with a copy of the bankruptcy petition and subpoenaed to appear before the court. He may plead that he has committed no act of bankruptcy and is not insolvent and demand a trial by jury, or he may otherwise contest the allegations before the court. Frequently, however, he fails to appear or plead, and the court adjudicates him a bankrupt. The assets are taken over by a receiver, if one is appointed by the court, and subsequently by the trustee.

The bankrupt prepares and files, under oath, detailed schedules of all his assets and all his creditors with the amount due each. At the first meeting of creditors, held not less than ten nor more than thirty days after the adjudication, the claims of the various creditors may be heard by the referee and, if valid, they are allowed. The debtor is examined with respect to his schedules, and the trustee is selected by the creditors or appointed by the court.

In the majority of cases, the assets are then liquidated, and the net proceeds used to discharge ratably the debtor's obligations to his creditors. Valid liens against assets of the bankrupt which are not voidable under the act must be paid first. The remaining assets are available to unsecured creditors, but a special group of priority claims are paid before the general creditors share in a distribution of the assets. These priority claims fit into six categories: (1) administrative costs; (2) wage claims, not to exceed $600 to each claimant, earned within three months prior to bankruptcy; (3) costs to creditors of opposing discharge and procuring convictions; (4) taxes legally due and owing by the bankrupt to the United States or to any state or any subdivision thereof; (5) debts owing to any persons who by the laws of the United States is entitled to priority; and (6) rent owing to a landlord who is entitled to priority by applicable state

law. The priority status of debts due the Federal government or its agencies is a frequent question under this general section.

The debtor is discharged from responsibility for his scheduled obligations unless he has been found guilty of some fraud or other violation of the Bankruptcy Act. There are several grounds for objection to discharge. These include (1) commission of a criminal offense, (2) destruction, falsification, or concealment of books and records, (3) issuance or publication of a false statement in regard to financial condition (a 1960 amendment eliminates the false financial statement as a ground for the complete denial of a discharge insofar as the individual non commercial bankrupt is concerned), (4) concealment of property, (5) refusal to obey court orders or to answer court approved questions, (6) prior discharge or composition within six years. Once the discharge has been granted, the bankrupt is in a position to begin his business career again without the burden of his former debts. However advantageous this may seem, it is not always an easy course, for it may take many years to live down the stigma of bankruptcy and rebuild a reputation for probity. Sometimes a debtor may later voluntarily pay in full the obligations that were only partially paid from his bankrupt estate.

Rehabilitation and reorganization proceedings are designed to meet the needs of the various types of debtor. Chapters VIII through XIII of the act provide relief for separate classes of debtor. Each chapter defines its applicability and its operation. Chapters VIII, XI, and XIII are closely affiliated in that they deal only with unsecured creditors. However, secured creditors, may, if desired, be affected by the plans under these chapters. The following discussion presents brief general statements on these chapters, with the exception of Chapter IX, which provides for taxing agencies or instrumentalities.

Agricultural Compositions and Extensions (Chapter VIII). Agricultural compositions and extensions may be filed by a farmer under Chapter VIII of the act. The terms of a composition or extension proposal may extend the time of payment of either secured or unsecured debts, or both, and may provide for priority of payments made during the period of extension as between secured and unsecured creditors. It may include specific undertakings by the farmer during the period of the extension, including provisions for payments on account, and may provide for supervisory or other control by a commissioner over the farmer's affairs during such period. The proposal may also provide for the termination of supervision or control under specified conditions.

An application for confirmation of a composition or extension pro-

posal must be accepted in writing by a majority in number and amount of all creditors whose claims have been allowed, including secured creditors whose claims are affected. The court shall confirm the proposal if satisfied that: (1) it includes an equitable and feasible method of both liquidation for secured creditors and financial rehabilitation for the farmer; (2) it is for the best interests of all creditors; and (3) the offer and its acceptance are in good faith.

Corporate Reorganizations (Chapter X). When its securities and stock are widely held by the public, a corporation can file under Chapter X. If a corporation can obtain the desired relief under Chapter XI, it cannot act under Chapter X.

Under Chapter X of the act a petition for corporate reorganization may be filed by a corporation or by three or more creditors who have claims against the corporation or its property amounting in the aggregate to $5,000 or more, liquidated as to amount, and not contingent as to liability. An order approving the petition shall be entered if the court is satisfied that it complies with the requirements of the act and has been filed in good faith. If the indebtedness of the debtor liquidated as to amount and not contingent as to liability is $250,000 or over, the judge shall appoint one or more trustees. If such indebtedness is less than $250,000, the judge may appoint one or more such trustees, or he may continue the debtor in possession.

The judge shall confirm a plan if satisfied that: (1) provisions of certain articles and sections of the chapter have been complied with; (2) the plan is fair, equitable, and feasible; (3) the proposal of the plan and its acceptance are in good faith and have not been made or procured by means of promises forbidden by the act; (4) all payments made or promised under the plan have been fully disclosed to the judge and are reasonable; and (5) the identity, qualifications, and affiliations of the persons who are to be directors, officers, or voting trustees upon the consummation of the plan have been fully disclosed, and the appointment of such persons is equitable, compatible with the interests of the creditors and stockholders, and consistent with public policy.

The plan and its provisions shall on confirmation be binding upon the debtor and every other corporation issuing securities or acquiring property under the plan and upon all creditors and stockholders, whether or not such creditors and stockholders are affected by the plan or have accepted it or have filed proofs of their claims or interest.

Upon consummation of the plan the judge shall enter a final decree (1) discharging the debtor from all its debts and liabilities and terminat-

ing all rights and interests of stockholders of the debtor, except as provided in the plan, (2) discharging the trustee, if any, (3) making such provisions by way of injunction or otherwise, as may be equitable, and (4) closing the estate

Arrangements (*Chapter XI*) All "persons" including corporations may file under Chapter XI However, the act expressly limits a Chapter XI proceeding to the voluntary action of the debtor An arrangement under this chapter shall include provisions modifying or altering the rights of unsecured creditors generally or of some class of them upon any terms or for any consideration Such arrangement may include

(1) provisions for treatment of unsecured debts on a parity one with the other, or for the division of such debts into classes and the treatment thereof in different ways or upon different terms,
(2) provisions for the rejection of any executory contract,
(3) provisions for specific undertakings of the debtor during any period of extension provided for by the arrangement, including provisions for payments on account,
(4) provisions for the termination, under specified conditions, of any period of extension provided by the arrangement,
(5) provisions for continuation of the debtor's business with or without supervision or control by a receiver or by a committee of creditors or otherwise,
(6) provisions for payment of debts incurred after the filing of the petition and during the pendency of the arrangement, in priority over the debts affected by such arrangement,
(7) provisions for retention of jurisdiction by the court until provisions of the arrangement, after its confirmation, have been performed, and
(8) any other appropriate provisions not inconsistent with this chapter

If the arrangement has been accepted in writing by all creditors, it shall be confirmed by the court when the debtor shall have made the deposit required under the chapter and under the arrangement, and if the court is satisfied that the arrangement and its acceptance are in good faith and have not been made or procured by any means, promises, or acts forbidden by the act

An application for confirmation of an arrangement that has been accepted by a majority in number and amount of creditors shall be confirmed by the court if (1) provisions of the chapter have been complied with, (2) it is for the best interests of the creditors and is feasible, (3) the debtor has not been guilty of any of the acts or failed to perform any of the duties that would be a bar to the discharge of a bankrupt, and (4) the proposal and its acceptance are in good faith and have not been made or procured by any means, promises, or acts forbidden by the act

Upon confirmation of an arrangement:

(1) the arrangement and its provisions shall be binding upon the debtor, upon any person issuing securities or acquiring property under the arrangement and upon all creditors of the debtor, whether or not they are affected by the arrangement or have accepted it or have filed their claims, and whether or not their claims have been scheduled or allowed and are allowable;
(2) the money deposited for priority debts and for the costs and expenses shall be disbursed to the persons entitled thereto;
(3) the consideration deposited, if any, shall be distributed and the rights provided by the arrangement shall inure to the creditors affected by the arrangement whose claims (*a*) have been filed prior to the date of confirmation and are allowed or (*b*) whether or not filed, have been scheduled by the debtor and are not contingent, unliquidated, or disputed; and
(4) the case shall be dismissed except as otherwise provided by the act.

Real Property Arrangements by Persons Other than Corporations (Chapter XII). The purpose of Chapter XII was to afford relief to those debtors who owned legal or equitable title to real property or chattels real. It does not apply to corporations. It became necessary because many states had corporate statutes prohibiting the formation of a corporation for the purpose of holding or dealing in real property. Chapter XII, generally stated, is a composite of Chapter X, in respect to its treatment of secured claims, and of Chapter XI, in respect to its treatment of unsecured debts and its procedural aspects. Chapter XII is seldom used at this time.

Wage Earners' Plans (Chapter XIII). The wage-earner proceedings of Chapter XIII can be commenced only by the voluntary act of the debtor. The practices in pleading that apply to ordinary bankruptcy proceedings are, with slight modifications, applicable to Chapter XIII proceedings. The schedules required in wage-earner proceedings are identical with those required in ordinary bankruptcy proceedings. Proceedings are commenced by the filing of an original petition by a debtor. A debtor may convert a pending ordinary bankruptcy proceeding, either before or after his adjudication, into a Chapter XIII proceedings by the filing in the pending ordinary bankruptcy proceedings of what is known as a "converter petition." The petition sets forth that the debtor is a wage earner who works, whose income does not exceed $5,000 per year, and whose domicile is within the jurisdiction of the court. It must also state the insolvency of the debtor and be accompanied by three exhibits—namely, a statement of his executory contracts, his schedules, and statement of affairs. The act provides only for a trustee and an attorney for the debtor. The duties of the trustee are not comparable with the conventional trus-

tee of ordinary bankruptcy proceedings. His duties are similar to the duties of the distributing agent provided for in Chapter XI proceedings. His compensation is "five percentum to be computed upon and payable out of the payments actually made by or for a debtor under the plan." If the petition sets forth all the jurisdictional allegations required, approval of the petition is not necessary. A plan under this chapter:

1. Shall include provisions dealing with unsecured debts generally, upon any terms.
2. May include provisions dealing with secured debts severally, upon any terms.
3. May provide for priority of payment during the period of extension as between the secured and unsecured debts affected by the plan.
4. Shall include provisions for the submission of future earnings or wages of the debtor to the supervision and control of the court for the purpose of enforcing the plan.
5. Shall provide that the court may from time to time, during the period of extension, increase or reduce the amount of any of the instalment payments provided by the plan, or extend or shorten the time for any such payments, where it shall be made to appear, after hearing upon such notice as the court may designate, that the circumstances of the debtor so warrant or require.
6. May include provisions for the rejection of executory contracts of the debtors.
7. May include any other appropriate provisions not inconsistent with the chapter.

If all the affected creditors have accepted the plan, it shall be confirmed by the court. The unanimous consent of all affected creditors is not necessary, however, as the plan shall be confirmed if a majority in number and amount accept it and if the following conditions are met:

1. The provisions of Chapter XIII have been complied with.
2. The plan is in the best interests of the creditors and is feasible.
3. The debtor has not been guilty of any of the acts or failed to perform any of the duties which would be a bar to the discharge of a bankrupt.
4. The proposal and its acceptance are in good faith and have not been made or procured by any means, promises or acts forbidden by the act.

Unique to this chapter is the provision that states that, "before confirming any such plan the court shall require proof from each creditor filing a claim that such claim is free from usury as defined by the laws of the place where the debt was contracted." Upon compliance by the debtor with the provisions of the plan and upon completion of all pay-

ments to be made thereunder, the court will enter an order discharging the debtor from his debts and liabilities provided for by the plan.

TRADE ASSOCIATION ASSISTANCE

In working out the problems of embarrassed businesses, trade associations often are extremely helpful. These associations occasionally conduct adjustment bureaus which co-operate with creditors' committees or actually perform the functions of creditors' committees. Where such bureaus are in operation, they attempt to hold down the costs of straightening out the affairs of debtors. In many cases they are peculiarly fitted to be of unusual assistance to creditors, because of their intimate knowledge and understanding of the debtor's business. The records of such bureaus in working out the problems of distressed businesses have been commendable.

chapter XXV

AT THE BANKER'S DESK

IN CONCLUDING THIS STUDY OF THE NUMEROUS FACTORS ENTERING into the sound extension of bank credit and of the broad background of knowledge required for the intelligent discharge of this major responsibility in our economic life, several actual requests for bank credit will be considered Illustrations of actual loan situations have been used in many chapters to clarify particular aspects of the main problem This chapter, however, will be devoted to the study of requests for loans which have been considered by bankers in various parts of the country Some of these requests were made at the desks of bankers in small villages, others were made at large metropolitan banking institutions They represent a typical cross-section of commercial bank loan activity geographically and industrially

All of these cases contain the essential facts with which the banker had to deal in making his decision Questions have been placed at the end of each case to emphasize various features of it and in some instances to determine whether the banker gave ample consideration to all of the facts Here we have an opportunity to sit at the banker's desk and to study the actual granting of credit in a practical, everyday manner, bringing to bear in these analyses the phases of the subject that have been discussed in the preceding pages

LOANS IN RURAL COMMUNITIES

Request for a Loan from a Debt Free Farmer

Cornelius Conway is a well-known farmer living in the little community of Cornfield, Iowa He is in his early fifties and has lived here his entire life, building up a reputation for reliability and integrity in all his business dealings

Mr. Conway is the owner of two hundred acres of land located six miles from town on a paved highway. The last addition to his farm was made twenty years ago, when he purchased sixty adjoining acres. While not a showplace, Conway's buildings are practical and in excellent condition. Over the years he has remodeled the existing barn and added several smaller buildings. Conway is a beef grower basically but also raises a few sheep and a number of hogs, as indicated on the statement in Figure 151. He has no mortgages on his real estate or personal property, and he has no unsecured debts. His account with the bank has been small but satisfactory. He has borrowed money from time to time and the bank is familiar with his record, which it views as excellent.

Recently he made a request to borrow $2,000 on an unsecured basis to be used to put a water system and a modern kitchen in his residence. Through the years he has used his earnings and savings to strengthen and improve that part of his farm operation that made profits—namely his farm buildings, the land, and livestock. His personal life has been conservative, even austere. He now feels that he can afford more comfort for himself and his family.

The balance sheet in Figure 151 gives effect to the $2,000 loan, which he feels he can liquidate within one year. He shows current assets of $13,750, largely livestock. His entire liability is represented by this one loan. All taxes have been paid to date. While his principal asset is his land, valued at $40,000, he appears well able to pay the loan within a year out of items that will be ready for market within that time.

Mr. Conway has met his obligations promptly in the past and undoubtedly would be able to discharge this debt as promised. His farming operations have been profitable and steady. A factor having a definite bearing on the loan is his clear farm. He would have no difficulty in securing a loan on the farm from the Federal Land Bank, an insurance company, or one of the many agencies in that field.

Summary

History: The customer has a splendid record of integrity.

Method of operation: The ability to operate his farm profitably has been amply demonstrated over the years. While conservative, his progress has been steady.

Bank information: His account, while small, has been entirely satisfactory, as has been his borrowing record.

Figure 151 Statement of Financial Condition Submitted to a Local Bank by Cornelius Conway

FARMER FINANCIAL STATEMENT

NAME Cornelius Conway — November 28 19—

BUSINESS Farmer — ADDRESS Cornfield, Iowa

TO First State Bank of Cornfield (NAME OF BANK)

FOR THE PURPOSE OF OBTAINING ADVANCES FROM TIME TO TIME ON BILLS, NOTES AND OTHER COMMERCIAL PAPER SIGNED OR INDORSED BY THE UNDERSIGNED, AND OF OBTAINING CREDIT GENERALLY, THE UNDERSIGNED MAKES THE FOLLOWING STATEMENT OF his FINANCIAL CONDITION AS OF THE CLOSE OF BUSINESS ON THE 28 DAY OF November 19—, AND CERTIFIES TO THE ABOVE NAMED BANK THAT THE INFORMATION HEREINAFTER SET FORTH IS IN ALL RESPECTS TRUE, ACCURATE AND COMPLETE AND CORRECTLY REFLECTS THE FINANCIAL CONDITION OF THE UNDERSIGNED ON THE DATE AFOREMENTIONED.

(FILL IN ALL BLANKS WRITING "NO" OR "NONE" WHERE NECESSARY TO COMPLETE INFORMATION)

ASSETS			
CASH ON HAND AND IN BANKS $		500	00
NOTES RECEIVABLE SECURED			
NOTES RECEIVABLE UNSECURED			
ACCOUNTS RECEIVABLE			
GOVERNMENT SECURITIES			
OTHER STOCKS AND BONDS (SEE SCHEDULE)			
LIVE STOCK (SEE SCHEDULE)	10	250	00
FARM PRODUCTS ON HAND (SEE SCHEDULE)	3	000	00
CASH VALUE OF LIFE INSURANCE			
OTHER CURRENT ASSETS			
TOTAL CURRENT ASSETS $	13	750	00
FARM LAND (SEE SCHEDULE) 200 ACRES IN Corn CO. @ $	40	000	00
CITY REAL ESTATE (SEE SCHEDULE)			
FARM MACHINERY, AUTOS, TRUCKS, TRACTORS AND OTHER EQUIP. (SEE SCHEDULE)	4	500	00
STOCKS & BONDS (GIVE DESCRIPTION & VALUE)			
1956 automobile		900	00
OTHER ASSETS			
TOTAL $	59	150	00
HAVE ENDORSED NOTES FOR OTHERS $ none			

LIABILITIES			
NOTES PAYABLE TO BANK—SECURED $			
—UNSECURED	2	000	00
NOTES PAYABLE TO OTHERS			
NOTES PAYABLE TO RELATIVES AND FRIENDS			
CHATTEL MORTGAGES			
ON LIVE STOCK			
ON MACHINERY			
CROP MORTGAGES COVERING ACRES			
DELINQUENT INTEREST			
DELINQUENT REAL ESTATE TAXES			
DELINQUENT PERSONAL TAXES			
CASH RENT DUE			
LOANS ON LIFE INSURANCE			
OTHER CURRENT LIABILITIES			
TOTAL CURRENT LIABILITIES $	2	000	00
MORTGAGES ON REAL ESTATE			
MORTGAGES ON CITY PROPERTY TO			
ALL OTHER DEBTS (ITEMIZE)			
TOTAL LIABILITIES			
NET WORTH	57	150	00
TOTAL $	59	150	00
AM BONDSMAN FOR OTHERS $ none			

LIVE STOCK

Age					
	HORSES @ $ PER HEAD $				
	MULES @ PER HEAD				
	COLTS @ PER HEAD				
	16 COWS STOCK @ 210 PER HEAD		3360		
3 yr.	3 Heifers 175 PER HEAD		525		
2 yr.	14 STEERS & heifers 210 PER HEAD		2940		
1 yr.	15 HEIFERS & steers 120 PER HEAD		1800		
	1 BULLS registered PER HEAD		350		
	FEEDERS @ PER HEAD				

CALVES @ $ PER HEAD $			
15 SOWS (bred) @ 65. PER HEAD		975	
PIGS @ PER HEAD			
STOCK HOGS @ PER HEAD			
SHEEP @ PER HEAD			
20 EWES @ 15. PER HEAD		300	
LAMBS @ PER HEAD			
TOTAL $	10	250	00

GRAIN AND FARM PRODUCTS

ON HAND			
2500 BU. CORN @ $ $		2250	
BU. WHEAT @			
500 BU. OATS @		300	
~~TONS~~ HAY & Ensilage @		450	
BALES COTTON @			
LBS. TOBACCO @			
BU. BARLEY @			
		3000	
TOTAL $			

GROWING CROPS	CONDITION			
ACRES CORN	$			
ACRES WHEAT				
ACRES OATS				
ACRES HAY				
ACRES COTTON				
ACRES TOBACCO				
ACRES BARLEY				
TOTAL $				

(BE SURE ALL SCHEDULES ON OTHER SIDE ARE FILLED OUT)

Financial information: Conway's nominal debt relative to his assets, his liquid position, and his steady earnings provide adequate protection for the loan.

Conclusion: The banker readily agreed to grant the loan.

Questions for Study

1. What particular factors do you think should be considered in making farm loans?

2. Does this type of loan differ in any way from a loan to a merchant in a small town?

3. How important is the past borrowing record of Mr. Conway in evaluating the present request for a loan? Under what conditions would you discount the past record of a borrower?

4. What information should a country banker keep in his credit file on a farmer who borrows?

Request for a Loan from a Farmer with a Mortgage Debt

Harold Madison, who is thirty-eight years old, owns 160 acres of farmland in southern Minnesota. Mr. Madison has twenty-five milk cows and sells Grade B milk, which gives him a sizable monthly income. The dairy business requires a lot of work, seven days a week. Mr. Madison during the past year had a gross income of $8,125 from his sale of milk. He now has concluded that he should go into Grade A milk production, as it would not entail much more work and should add in the neighborhood of $2,000 to his milk income without much additional expense. Since the sanitation requirements on Grade B production are becoming steadily more rigorous, he feels he might as well go all the way to Grade A.

Mr. Madison has borrowed at the bank from time to time, usually for short periods to buy feed. He has taken good care of any advances in the past and seems to be able to anticipate his income properly and never borrows more than he can conveniently pay. He is a good farmer and has steadily improved his operation, using his earnings to modernize his buildings, grade up his dairy herd, and improve his land. He also has a successful hog operation. His account has not been large but has always been satisfactory.

To go from a Grade B dairy operation to Grade A will take equipment to the extent of about $3,500, of which Madison has $500 and wishes to

borrow $3,000 He offers to secure the bank with a chattel mortgage on his cattle and give an assignment of his milk check for $150 monthly to liquidate the loan

The principal difference between this man's financial position and that of Cornelius Conway lies in the mortgage that Madison owes to the Federal Land Bank. From an operating point of view, Conway's expense with a clear farm is conservative Madison must pay not only interest but also principal payments In addition, he has no possibility of borrowing on his land as Conway has

Madison is progressive and through the years has shown excellent judgment in his approach to improvements and changes in his operation. His record of payment has been good The security he offers appears more than adequate, and if his estimate is correct, the additional income secured by going Grade A will provide the monthly payments of $150

His statement (Figure 152) shows a good current position He has no debt except on the farm, and that is stretched over a long period ahead with nominal payments

Summary

History Mr Madison is an aggressive farmer with an impressive record

Method of operation He has proved himself to be a progressive dairyman and is young, willing, and able to do the hard and confining work necessary for getting ahead in this field

Bank information Madison has proved to be a payer and not a renewer When he borrows, he plans and his plans work out.

Financial information His hog operation makes his farm payments and, with his dairy income, appears adequate to make his living, pay his expenses, and meet the promised payments

Conclusion The banker agreed to grant the loan

Questions for Study

1 Would you include the local bank stock for $200 in the current assets?

2 Should the banker have made an unsecured loan in view of the mortgage indebtedness on the land and buildings?

3 Why might Mr Madison require a bank loan of $3,000 though his bank balance averages $500?

4 What facts, if any, should the banker examine in relation to mort-

Figure 152 Statement of Financial Condition Submitted to a Local Bank by Harold Madison

FORM NO. AB-1—FARMER
PRINTED BY DELANO SERVICE, INC., ALLEGAN, MICH.

FARMER FINANCIAL STATEMENT

NAME Harold Madison   December 15 19—

BUSINESS Farmer   ADDRESS Oatfield, Minnesota

TO Farmers State Bank of Oatfield
(NAME OF BANK)

FOR THE PURPOSE OF OBTAINING ADVANCES FROM TIME TO TIME ON BILLS, NOTES AND OTHER COMMERCIAL PAPER SIGNED OR INDORSED BY THE UNDERSIGNED, AND OF OBTAINING CREDIT GENERALLY, THE UNDERSIGNED MAKES THE FOLLOWING STATEMENT OF his FINANCIAL CONDITION AS OF THE CLOSE OF BUSINESS ON THE 15 DAY OF December 19— AND CERTIFIES TO THE ABOVE NAMED BANK THAT THE INFORMATION HEREINAFTER SET FORTH IS IN ALL RESPECTS TRUE, ACCURATE AND COMPLETE AND CORRECTLY REFLECTS THE FINANCIAL CONDITION OF THE UNDERSIGNED ON THE DATE AFOREMENTIONED

(FILL IN ALL BLANKS, WRITING "NO" OR "NONE" WHERE NECESSARY TO COMPLETE INFORMATION)

ASSETS			
CASH ON HAND AND IN BANKS $		1200	00
NOTES RECEIVABLE SECURED			
NOTES RECEIVABLE UNSECURED			
ACCOUNTS RECEIVABLE			
GOVERNMENT SECURITIES			
OTHER STOCKS AND BONDS (SEE SCHEDULE)			
LIVE STOCK (SEE SCHEDULE)	10	860	00
FARM PRODUCTS ON HAND (SEE SCHEDULE)	3	000	00
CASH VALUE OF LIFE INSURANCE			
OTHER CURRENT ASSETS			
Bank stock		400	00
TOTAL CURRENT ASSETS $	15	460	00
FARM LAND (SEE SCHEDULE)			
160 ACRES IN Oat CO @ $	30	000	00
CITY REAL ESTATE (SEE SCHEDULE)			
FARM MACHINERY, AUTOS, TRUCKS, TRACTORS AND OTHER EQUIP (SEE SCHEDULE)	2	700	00
STOCKS & BONDS (GIVE DESCRIPTION & VALUES)			
Dairy equipment	3	500	00
1957 automobile	1	100	00
OTHER ASSETS			
TOTAL $	52	760	00

LIABILITIES			
NOTES PAYABLE TO BANK—SECURED $	3	000	00
—UNSECURED			
NOTES PAYABLE TO OTHERS			
NOTES PAYABLE TO RELATIVES AND FRIENDS			
CHATTEL MORTGAGES			
ON LIVE STOCK			
ON MACHINERY			
CROP MORTGAGES			
COVERING ACRES			
DELINQUENT INTEREST			
DELINQUENT REAL ESTATE TAXES			
DELINQUENT PERSONAL TAXES			
CASH RENT DUE			
LOANS ON LIFE INSURANCE			
OTHER CURRENT LIABILITIES			
TOTAL CURRENT LIABILITIES $	3	000	00
MORTGAGES ON REAL ESTATE Fed Land Bk	20	000	00
MORTGAGES ON CITY PROPERTY			
TO			
ALL OTHER DEBTS (ITEMIZE)			
TOTAL LIABILITIES	23	000	00
NET WORTH	29	760	00
TOTAL $	52	760	00

I HAVE ENDORSED NOTES FOR OTHERS $ I AM BONDSMAN FOR OTHERS $

LIVE STOCK

HORSES @ $ PER HEAD $			
MULES @ PER HEAD			
COLTS @ PER HEAD			
COWS, STOCK @ PER HEAD			
25 COWS, DAIRY @ 300 PER HEAD		7500	00
STEERS @ PER HEAD			
10 HEIFERS com. 2 @ 175 PER HEAD		1750	00
BULLS @ PER HEAD			
12 ~~XXXXX~~ heifer calves @ 80 PER HEAD		960	00

CALVES @ $ PER HEAD $			
10 SOWS (bred) @ 65 PER HEAD		650	00
PIGS @ PER HEAD			
STOCK HOGS @ PER HEAD			
SHEEP @ PER HEAD			
EWES @ PER HEAD			
LAMBS @ PER HEAD			
TOTAL $	10	860	00

GRAIN AND FARM PRODUCTS

ON HAND			
2000 BU CORN @ $		1800	00
BU. WHEAT @			
1000 BU OATS @		600	00
~~XXXX~~ HAY and feed @		600	00
BALES COTTON @			
LBS TOBACCO @			
BU BARLEY @			
TOTAL $		3000	00

GROWING CROPS	CONDITION			
ACRES CORN				
ACRES WHEAT				
ACRES OATS				
ACRES HAY				
ACRES COTTON				
ACRES TOBACCO				
ACRES BARLEY				
	TOTAL $			

(BE SURE ALL SCHEDULES ON OTHER SIDE ARE FILLED OUT)

gage indebtedness when he considers a short time loan to a borrower so obligated?

5 Enumerate the particular hazards that may confront those engaged in dairying

A Slow Farm Operating Loan

The Citizens Bank of Arlene, Kansas, held a note of William Baker and his wife, tenant farmers, in the amount of $3 000 secured by live stock and farm machinery valued at $4,500 Baker had worked for some years as a hired hand, lived frugally, and accumulated a used automobile and $2 000 of savings With the help of the bank he started farming While loans of this type are usually not among the most desirable credits, the banker had acquired considerable respect for Baker and felt some obligation to help young farmers get started

After Baker got married, his earnings for several years went into household furniture, small equipment, and tools he needed and within a few years he and his wife had two children During this period farm prices declined, and Baker found it difficult to get ahead As a result the loan remained steady at $3 000 and the bank examiner began to be critical of the fact that no reductions were being made

In the current spring just as crops were to be put in Baker contracted polio, and it was necessary to remove him to the state hospital The case attracted wide attention and sympathy not only in Baker s immediate neighborhood but throughout the community The neighbors got together, did Baker s plowing, seeding, and planting and got the crop in Baker returned home from the hospital but was unable to work, and hired help was necessary

At this point Baker and his wife became concerned over the expense of his illness and the added burden of hired help and offered to have a sale to liquidate the indebtedness as much as possible Indications were that Baker would now make a complete recovery His crop was good so the bank decided to continue with him In view of the examiner's criticism, the board concluded that $1,500 of the loan should be charged off, but, of course, this was not known to Baker

A little later the Bakers informed the banker that Mrs Baker had inherited $1,000 from her mother's estate They asked the banker for an additional loan of $1,000 to enable them to buy thirty five head of Hereford steer calves, which would be pledged to secure the total bank loan of $4,000

The Bakers had sufficient feed and pasture to handle the additional cattle, and Baker had just about made a complete recovery. They had been customers of the bank for some years and were good farmers, thoroughly dependable, and honest. Their bank balance had always been satisfactory. By selling the security pledged, the banker could have realized the $1,500 at which he was now carrying the note on his books, plus some besides. But such action would have put the Bakers out of the farming business. The additional $1,000 loan was granted.

In the next twelve months the cattle market improved, and Baker fed the cattle to 1,000 pounds and paid off his entire line. As time passed, the Bakers continued to prosper and were able to purchase their own farm; they have become stable citizens of the community, comfortably fixed financially.

Summary

History: The borrowers were experienced and capable farmers. Misfortune over which they had no control caused their difficulties.

Method of operation: Their income had always been adequate to pay their living expenses, which were conservative, and to accumulate some added property until Baker's illness.

Bank information: Entirely pleasant relationship over the years both in their account and in their borrowings.

Financial information: When made, their loan was adequately secured, but with declining income and heavy expense, it deteriorated through no fault of Baker.

Conclusion: The banker's confidence in the borrower enabled him, through an additional loan, to liquidate a slow line. In addition, the bank was able to avoid "selling out" a good citizen as well as the stigma accompanying such action. Indeed, the bank's assistance developed many friends for the bank, as a result of Baker's good standing in the community and the wide attention his illness had attracted in the vicinity.

Questions for Study

1. Should a banker always sell the security pledged for a loan before the value of the security falls to a point where the bank may experience a loss? Is this always possible? Why?

2. If a borrower is already in financial difficulties and unable to repay

a bank loan, under what circumstances, if any, would you as a banker loan the borrower additional funds?

3. Do you believe that the character of the borrower is more or less important than his collateral? Why?

4. Is it the responsibility of the banker to decline a request for a loan that is adequately secured by good collateral if he is reasonably certain that the particular enterprise into which the money is to be put will not succeed?

PERSONAL LOANS

Small Loan for the Modernization of an Urban Home

Mr. James Harland made application to his bank for a modernization loan of $1,600, with which he planned to convert a large two-family residence into a four-family house at an expense under contract of $3,200. He had cash in a savings account amounting to $1,600 and wished to borrow $1,600 to make up the full amount of the $3,200 that he needed.

The bank was already holding a first mortgage of $6,000 on the property, which had an estimated market value of $19,000. Interest payments on the mortgage had always been paid on or before the due date.

As soon as the application for the loan was received, an inspection was made of the property and the plans. Contracts in connection with the alterations were also carefully reviewed. The inspector reported that the layout was well planned and practical and that the cost of the alteration was moderate. Harland stated that if he could secure the loan to make the alterations, he could rent the apartments to advantage. In fact, he had received written applications for leasing three of the apartments as soon as they were ready.

Based upon estimated costs and the further fact that Harland had been steadily employed for twelve years as a bookkeeper in a produce commission business with a present salary of $6,000 per annum, the banker made the $1,600 loan. The money was advanced when the alteration was completed with the understanding that repayment of $50 would be made monthly.

On this particular modernization loan, repayments were nearly always well in advance and in no instance after the due date. The property was fully rented, as had been anticipated. The loan was paid in full according to terms, and the friendly relationship of the banker and the borrower was further strengthened.

Summary

History: Mr. Harland was a thrifty individual, whose work record had been most conscientious and whose integrity was unquestioned.

Method of operation: This venture was outside Harland's regular employment, but he possessed evidence indicating that it would be profitable.

Bank information: The borrower had a savings account in which he had regularly made deposits for many years.

Financial information: The equity of the borrower in the property and the size of his salary justified the extension of the loan.

Conclusion: The loan was made and repaid satisfactorily according to agreement.

Questions for Study

1. Is it ever good policy to make loans to individuals without a balance sheet or collateral?
2. If the banker were satisfied with the collateral offered, would it be necessary to inquire about the purpose of a loan? Why?
3. What factors would you consider in fixing the interest rate to be charged a borrower on a loan?
4. Does the fact that a borrower wishes to use the funds outside his regular business ever merit consideration?
5. What, if any, risk was there in this loan?

Loan on Marketable Collateral

Dr. James Flood, a successful dentist, had practiced for twelve years in a moderate-sized Indiana city. He contemplated the purchase of new dental equipment, costing $3,500, and asked his banker for a loan of this amount to enable him to pay cash. The balances in Dr. Flood's checking account had averaged in the neighborhood of $800 for several years. He owned $10,000 of good stocks, listed and actively traded in on the New York Stock Exchange. He did not wish, however, to sell any part of these securities. His income was $12,000 annually, and his losses from bad debts were less than 2 per cent annually. As collateral, he offered the banker listed stock with a market value of $5,000 and explained that he planned to retire the loan at the rate of $250 monthly.

Summary

History Dr Flood had an established clientele and a successful record in his profession

Method of operation His work was done largely on a cash basis Now and then credit was necessary, however, to patients with small incomes.

Bank information Bank balances were satisfactory No loan had ever been sought previously

Financial information Dr Flood s securities represented adequate col lateral The stock market could decline considerably, and the loan would still be protected, particularly in view of the monthly payments. More over, he had $5 000 in good unpledged securities

Conclusion. The banker granted the loan, making out the note for ninety days with the understanding that renewals for the unpaid balance would be granted each ninety days until the loan was paid.

Questions for Study

1 What information would you wish regarding stocks offered as collateral to a loan Bonds

2 Is the maturity of a loan important if you have adequate collateral

3 Consider the last three cases—the Bakers' loan, Mr Harland s loan, and the request of Dr Flood. To which would you give the lowest inter est rate? Why?

4. Do you think there are any circumstances under which the banker might advise Dr Flood to sell his securities to obtain funds, rather than to borrow?

INDUSTRIAL AND COMMERCIAL LOANS

Loan to a Manufacturer of Kitchen Utensils

The Kitchen Company, Inc., a Tennessee corporation manufacturing small metal kitchen utensils, was organized about twenty five years ago Its products were marketed through both chain stores and independent retailers The early history of the business was somewhat turbulent be cause of a number of adverse factors, among which were mediocre man agement and inadequate capital. The management incurred heavy liabilities, the bulk of which represented indebtedness to the Johnson Corporation, the principal source of raw materials. The latter had been lenient

in its credit policy since the Kitchen Company, Inc., promised to become one of its important outlets.

Matters ultimately reached the point, however, where the Johnson Corporation lost confidence in the ability of the management to develop operations soundly. A meeting of the creditors was called, and the affairs and prospects of the enterprise were carefully examined. Out of that conference an agreement was drawn up, whereby the creditors arranged to accept stock in lieu of their claims provided that a qualified executive, satisfactory to them, would be brought in and given complete control. The Johnson Corporation offered to purchase at a discount the claims of the few creditors who did not care to go along on this basis. With the net working capital thus augmented and the management problem apparently improved, the concern began to show progress almost immediately, and operations were soon on a profitable basis.

Over succeeding years cash dividends were paid regularly, and several increases were made in the outstanding capital stock through stock dividends. The progress was attributable in large part to the ability and aggressiveness of the new executive. By this time it was felt that the enterprise might use additional banking facilities, and so about five years ago a change was made: the major portion of the account was transferred to a larger banking institution in St. Louis. The account had been solicited by a vice-president of this bank for several years through his friendship with the new executive. The banker was convinced of the desirability of the account, not only because of his respect for the ability and integrity of the managing head, but also because of his knowledge of the financial progress over the years obtained from the reports of Dun & Bradstreet, Inc.

Loan Record—In year C, two years after the account was opened at the St. Louis bank, a $75,000 unsecured loan for ninety days was requested for current seasonal purposes. Upon reviewing the history of the business and the splendid current position shown in the June 30, year C, balance sheet, the banker had had no hesitancy in making the credit available. The balance sheets for the immediately preceding years had likewise indicated satisfactory conditions. The loan was liquidated strictly according to agreement. There were no further borrowings in years C or B.

For the twelve months ending June 30, year A, an expansion in volume took place, and it became evident that bank credit would be needed to carry the expanding receivables and inventory. Accordingly, the president asked for a commitment of $150,000. The balance sheets for the

three-year period then appeared as shown on the comparative statement page of the bank credit folder (Figure 153)

Financial Condition—The comparative financial condition disclosed by these three statements indicated handsome profits and the maintenance of a uniformly healthy condition of affairs Net profits for the fiscal year C

Figure 153 Comparative Balance Sheets for the Kitchen Company, Inc (*for years ended June 30, 19—*)

	(C) Three Years Ago	(B) Two Years Ago	(A) One Year Ago
ASSETS			
Cash on Hand and in Banks	\$ 50 000	\$100 000	\$ 20 000
Accounts Receivable	61,000	65 000	93 000
Merchandise	125,000	115,000	160 000
U S Government Securities	15 000	55 000	50 000
Current Assets	\$251,000	\$335,000	\$323,000
Prepaid Items	6,000	4,000	10,000
Real Estate and Buildings	210 000	215,000	225 000
Machinery and Fixtures	177,000	183 000	218 000
Other Assets	2 000	1,000	10 000
Total	\$646 000	\$738 000	\$786 000
LIABILITIES			
Accounts Payable	\$ 5,000	\$ 3,000	\$ 6,000
Federal Income Taxes	30,000	28,000	34,000
Accruals	5 000	15 000	10 000
Current Liabilities	\$ 40,000	\$ 46 000	\$ 50,000
Reserves for Depreciation	146,000	171,000	197,000
Common Stock	335,000	335,000	335,000
Surplus	125,000	186 000	204 000
Total	\$646,000	\$738,000	\$786 000
Net Working Capital	\$211,000	\$289 000	\$273,000
Current Ratio	6 27	7 28	6 46
Tangible Net Worth	\$460 000	\$521 000	\$539,000
Net Sales	\$875,000	\$693,000	\$772 000
Net Profits	240,000	210,000	198,000
Dividends	125 000	149,000	180,000

represented 52 per cent on the tangible net worth and for year A, 36 7 per cent A substantial portion of the profits had been paid out in dividends during each of the three years, but at the same time an exceptionally liquid condition had been maintained Current liabilities on each of the three statement dates were low, and the depreciated value of fixed assets was in satisfactory proportion to the combined capital and surplus funds Receivables and merchandise were likewise in satisfactory proportions

Summary

History: The early history of the corporation had been distinctly unfavorable, but with a change in management, an immediate improvement took place.

Method of operation: The concern manufactured small kitchen utensils which were sold through retail outlets. After the change in management its sales rose to substantial proportions.

Bank and trade information: The limited experience of the bank prior to the extension of credit had been satisfactory. The trade information and the reports of Dun & Bradstreet, Inc., had been complimentary during recent years.

Financial information: The banker felt that the balance sheets fully warranted the credit requested. Cash alone in years C and B was in excess of the total liabilities, and in year A the total of cash and United States Government securities exceeded all of the liabilities.

Conclusion: The loan was granted on an unsecured basis with the understanding that it would be liquidated periodically and that commensurate balances of 15 to 20 per cent of the line would be maintained.

Questions for Study

1. Should the Johnson Corporation, as a substantial stockholder, have been required to guarantee the credit in year C?

2. Under what circumstances would an outside endorsement or guaranty be warranted?

3. In judging the enterprise as a credit risk, should any consideration be given to its early history, or should this unfavorable record be disregarded in favor of its successful operations following the change in management?

4. Why are "commensurate balances" ordinarily desired by a bank making available a line of credit?

5. Let us assume the Johnson Corporation owns 40 per cent of the capital stock of the Kitchen Company, Inc. Would you classify the concern as a subsidiary or an affiliate, or attach no significance to the stock ownership?

6. Was a line of $150,000 excessive in relation to net working capital or tangible net worth?

Loan to a Highway Construction Company

The Highway Construction Company, Inc, located in Middleboro, a large city in Ohio was incorporated in 1923 succeeding an individual business which had been conducted by P T McIntyre for six years At the time of the incorporation Mr McIntyre sold a substantial interest to his son in law, W E. Larson a construction engineer, and five years later retired from active participation in the business

The enterprise specialized in highway and street construction, operating a well-equipped asphalt plant in Middleboro, and maintaining a complete line of road construction and maintenance equipment. Most of the roads in this section of the state had been paved or hard-surfaced fifteen to twenty years previously, so that for a number of years the only work available to contractors consisted of resurfacing and widening of which, however, there continued to be a considerable amount.

Loan Record—The concern opened an account with the Middleboro National Bank and Trust Company early in year B Borrowings reached $5 000 in year B and $25 000 in year A Satisfactory balances had been maintained Loans had been made for comparatively short periods and had been retired promptly Borrowings had been on an unsecured basis, but had been guaranteed by Messrs McIntyre and Larson

In March Mr Larson called on his banker with his balance sheet as of December 31, year A and sought a line of $35 000 for the current year with provision for an additional $15 000 for a temporary period, if needed The balance sheet had been prepared by his own bookkeeper He stated that the business was confining its activity to Federal and state contracts exclusively, and that any borrowed funds would be used for working capital purposes principally labor materials, and freight, as no additions to equipment or other fixed assets were needed

Mr Taylor, the vice president of the bank who handled the account, had called at the plant and inspected jobs in process from time to time. He had satisfied himself regarding the adequacy of the equipment, the physical properties, and the quality of the work The bookkeeping and accounting methods had been periodically examined by a member of the bank's credit department and had been found satisfactory A recent Dun and Bradstreet report in the file and checkings with trade creditors, completed by the credit department within the last sixty days, indicated that current invoices were being discounted or paid promptly

The credit department had also checked with bonding companies that

had executed construction bonds for the corporation, and had been assured that, in consideration of their favorable experience, the bonding companies would certainly continue to solicit the account. The credit examiner for the Department of Highways, State of Ohio, had recently replied to an inquiry that the concern's work and methods of payment had been entirely satisfactory, and that they felt that sufficient current assets were available to enable the enterprise to handle any contract of

Figure 154 Comparative Balance Sheets for Highway Construction Company, Inc. (*for years ended December 31, 19–*)

	(C) Three Years Ago	(B) Two Years Ago	(A) One Year Ago
ASSETS			
Cash	$ 2,600	$ 5,400	$ 13,000
Receivables	67,800	22,900	16,700
Merchandise	1,000	2,200	2,100
Securities, at market	-	-	3,000
Current Assets	$ 71,400	$ 30,500	$ 34,800
Machinery and Equipment	49,000	52,900	53,200
Receivables from Stockholders	6,000	11,500	12,200
Due from Affiliate	-	3,700	-
Other Assets	900	1,200	3,500
Total Assets	$127,300	$ 99,800	$103,700
LIABILITIES			
Notes Payable - Banks	$ -	$ 5,000	$ -
Accounts Payable	28,000	7,000	7,700
Accrued Liabilities	400	900	1,100
Current Liabilities	$ 28,400	$ 12,900	$ 8,800
Capital Stock	50,000	50,000	50,000
Surplus	48,900	36,900	44,900
Total Liabilities	$127,300	$ 99,800	$103,700
Net Working Capital	$ 43,000	$ 17,600	$ 26,000
Current Ratio	2.52	2.36	3.95
Tangible Net Worth	$ 98,900	$ 86,900	$ 94,900

reasonable amount. In conversations with other contractors, the local city service director, and county officials, Mr. Taylor had further confirmed his favorable impressions of the management.

Year-end balance sheets and profit and loss statements for the years C, B, and A inclusive, as set up on the bank credit department's comparative form, and operating figures for the three annual periods are shown in Figures 154 and 155. The losses sustained two and three years ago were the only losses in the history of the corporation since its inception. The loss of $12,900 in year C, in spite of a substantial volume of business, had

been explained by Mr Larson as resulting from a combination of circumstances Competition for available business had been exceedingly keen at that time, and it had been necessary to figure very closely in order to obtain business This unsatisfactory profit situation was recognized fully, but it had been considered desirable to accept such business at the time in order to absorb the overhead and keep the organization intact The salaries paid Messrs Larson and McIntyre had been excessive in view of

Figure 155 Profit and Loss Accounts for Highway Construction Company, Inc (*for years ended December 31, 19—*)

	(C) Three Years Ago	(B) Two Years Ago	(A) One Year Ago
Total Work Completed	\$337 200	\$ 48 900	\$253 900
Cost of Completed Work (Labor Materials Small Tools etc)	319 500	44 100	227 800
Gross Prof t	\$ 17 700	\$ 4,800	\$ 26,100
Administrative Expenses			
Officers Salaries	\$ 12 000	\$ 4,100	\$ 7,800
Miscellaneous Expenses	21 300	8 300	11 100
Maintenance of Equipment and Previous Years Contracts	4 500	7 000	900
Total Administrative Expenses	\$ 37 800	\$ 19 400	\$ 19 800
	\$ 20 100 (L)	\$ 14 600 (L)	\$ 6 300
Add			
Discount on Purchases and Rental on Equipment	7 200	2 600	3 200
Net Profit or Loss	\$ 12 900 (L)	\$ 12 000 (L)	\$ 9,500
Less			
Reduction in Securities to Market	-		1 500
Surplus Change	\$ 12 900 (L)	\$ 12 000 (L)	\$ 8 000

the operating situation, but had been maintained to enable them to liquidate pressing personal liabilities Expenses had been somewhat higher than anticipated because of unfavorable weather, resulting in a delay in the completion of several projects until well into the winter, with a resultant increase in operating costs

The principal factor responsible for the loss of \$12,000 in the year B was the decline in annual volume to \$48,900 Realizing that the prospect of securing any adequate volume in that year was extremely problematic, Mr Larson had concentrated on reducing overhead expenses and on overhauling and repairing equipment In spite of a comparatively negligible amount of construction work, the gross profit margin had increased percentage-wise, and officers' salaries and other administrative expenses

had been reduced, limiting losses to an amount slightly below that of the preceding year.

Improved conditions reflected a substantial increase in volume from \$48,900 to \$253,900 and resulted in a satisfactory final profit and increase in surplus of \$8,000 in the last fiscal year. Mr. McIntyre had been removed from the payroll two years before, and every effort had been made to limit overhead and administrative expenses. Total administrative expenses of \$19,800 for year A were only \$400 greater than during the preceding year.

Discussion of the balance sheet for year A brought out the fact that receivables of \$16,700 included \$14,000 retained by the State of Ohio until the spring inspection of the last job. The remainder, amounting to \$2,700, was due from a county in northeastern Ohio and represented a balance owed on work performed two years previously, which, according to agreement, would be liquidated within eleven months from the date of the balance sheet. Securities of \$3,000 consisted of special assessment bonds with a par value of \$4,500 and were carried at market value.

Receivables from stockholders of \$12,200 had increased \$700 during the year. Mr. Larson explained, however, that he and Mr. McIntyre, to whom the advances had been made, had reduced their indebtedness \$3,000, and that the increase was the result of the fact that Mr. McIntyre had assumed \$3,700 advanced to another company in which he was interested. This advance had appeared in the balance sheet for year B under the caption "Due from Affiliate."

The banker realized that a line of \$50,000 was very liberal in proportion to the net working capital of the corporation. His own experience, however, had convinced him that Mr. Larson was a careful and conservative operator and that his estimates had been unusually accurate. A considerable amount of highway repair was to be expected as the result of Federal and state programs, and prospects of obtaining sufficient work on a profitable basis appeared favorable. As any credit extended would be employed in financing Federal and state projects, the concern would not be forced to carry receivables over an indefinite period. Payment could be expected within a short time after the completion of its job, and the possibility of credit losses was obviously negligible.

Recognizing the existence of keen competition, the hazards of unfavorable weather—particularly in the late fall months when remaining contracts would have to be pushed to completion—and the rather limited amount of working capital at the company's disposal, Mr. Taylor nevertheless believed that with an established reputation and exceptionally able

management, the concern was entitled to a somewhat larger line of credit than would perhaps be warranted in ordinary circumstances Should the concern be unable to secure sufficient volume to operate profitably, no credit accommodation would be needed, and the line would not be used

Summary

History The business had an established reputation and had been competently managed

Method of operation The management had shown its ability to adjust itself to a relatively small volume Prospects of additional volume were good Contracts were accepted only from Federal and state governments

Bank and trade information Satisfactory bank balances had been carried, and previous loans had been retired promptly Trade creditors reported that payments had been made promptly or discounted Bonding companies reported satisfactory experience and would continue executing construction bonds The state highway department report was favorable

Financial information The net working capital was modest in relation to the credit desired Expanding volume on a profitable basis should increase working capital No new equipment was needed Operating expenses had been reduced

Conclusion The banker agreed to extend a credit commitment up to $50,000, to be guaranteed by Messrs McIntyre and Larson, and with the understanding that he reserved the privilege of analyzing the performance and prospects of the business at intervals during the year, particularly when any sizable projects were under contemplation

Questions for Study

1 Why is the ability of the management of the Highway Construction Company, Inc, a particularly important factor in the consideration of the line of credit requested?

2 Are the explanations for the losses incurred in years C and B logical?

3 Would a line of $50 000 normally be considered excessive in comparison to (1) net working capital and (2) tangible net worth? What factors influenced the loaning officer to approve a commitment of this size? Could such a commitment safely be extended to a building contractor? Why, or why not?

4. Why would it be desirable to have the credit guaranteed by Mr

Larson even though he might have no assets of importance aside from his interest in the Highway Construction Company, Inc.?

Loan to a Box Lumber Manufacturer

The Box Lumber Company, Inc., a California corporation, has had its headquarters at Bytown in northern California since its organization in 1919. The company owned one hundred acres of land within the town limits, improved with a sawmill, box factory, planing mill, dry kilns, and a lumber yard. The sawmill had a capacity of 175,000 feet of lumber for each eight-hour shift and produced annually an average of 120,000,000 feet of lumber. The machinery and equipment were modern. The property was provided with spur tracks, giving direct access to the Southern Pacific and the Great Northern railroads.

From its own timberlands and from government timber leases, a supply of timber sufficient for fifteen years or more was available. This timber compared favorably with the average in the district. The lumber produced in the mill ran 35 per cent number two shop, or better, and 65 per cent box lumber. The lower grades were used mostly for box shook, of which this concern was the largest manufacturer in its territory. Most of the upper grades of lumber were kiln-dried, which took about five days against the forty-five to sixty days required to dry one-inch lumber in the air.

Mr. B. A. Wood, the president and general manager, had spent most of his life in the lumber business. He was considered capable and stood well among his competitors as a sawmill operator. He had developed an excellent administrative staff, so that the concern was not a one-man organization.

A bank in a neighboring large city had had the main account since the organization of the business. Balances had been satisfactory until year C, when they began to run a little low.

Up to five years ago the business operated successfully and had built up a healthy surplus from earnings after dividends. At that time a block of timber (approximately 800,000,000 feet) was purchased at a price somewhat in excess of $2,600,000. As part payment, $550,000 of 7 per cent cumulative preferred stock was given, the stock to be redeemed at the rate of $110,000 per year beginning six years later. Timber purchase serial notes were given in payment of the balance of the obligation, to be retired at the rate of $250,000 per annum, plus 7 per cent interest on the

unpaid balance This purchase entailed heavy expenditures for the construction of a logging railroad to bring out the timber The construction of the railroad was partly financed by a mortgage on the road itself One year later, the carrying charges on these new obligations, plus the effect of a depression, reduced the net profits to $82,127 compared to $240,000 for the preceding year

Balance sheets for the years E to A inclusive, in Figure 156, show the

Figure 156 Comparative Balance Sheets for Box Lumber Company, Bytown, California (*for years ended December 31, 19—*)

	(E) 5 Years Ago	(D) 4 Years Ago	(C) 3 Years Ago	(B) 2 Years Ago	(A) 1 Year Ago
ASSETS					
Cash	$ 4[illegible] 879	$ 5[illegible] 633	$ 2[illegible] 500	$ 23 523	$ 2[illegible] 547
Notes Receivable	19 180	13 600	2 887	13 385	12 077
Accounts Receivable	187 750	71 762	79 335	78 505	74 629
Merchandise	661 054	631 717	352 8[illegible]3	452 917	348 899
Current Assets	$ 833 604	$ 764 712	$ 460 535	$ 573 427	$ 452 573
Real Estate, Timber Lands, Plant and Equipment less Depreciation	4 272 284	4 195 000	4 257 477	3 832 643	3 881 636
Investments	185 302	13 [illegible]95	45 065	37 935	37 935
Sundry Accounts Receivable				19 4[illegible]5	85 554
Prepaid Expense	25 046	48 1[illegible]4	47 938	68 [illegible]	52 030
Total Assets	$5 3[illegible]6 236	$5 138 74[illegible]	$4 8[illegible]1 815	$4 524 2[illegible]7	$4 459 526
LIABILITIES					
Notes Payable to Bank	$ 179 000	$ 190 000	$ 100 000	$ 50 000	$ 50 000
Timber Purchase Serial Notes Current		250 000	250 000	250 000	
Accounts Payable	44 162	39 067	29 447	45 395	48 876
Taxes			24 193	56 197	93 778
Other Liabilities	68 736	156 989			137 840
Current Liabilities	$ 282 898	$ 546 056	$ 4[illegible]3 637	$ 4[illegible]2 592	$ 377 465
First Mortgage Bonds	375 000	32 000	27 000	272 000	195 000
Mortgage Notes on Railroad			375 000	399 969	4[illegible]9 730
Timber Purchase Serial Notes	2 [illegible] 764	1 883 62[illegible]	1 589 666	1 399 545	2 139 609
7 Per Cent Cumulative Preferred Stock	550 000	550 000	557 0[illegible]3	553 000	
Common Stock	1 0[illegible]0 000	1 0[illegible]0 000	1 0[illegible]0 000	1 000 000	1 000 000
Surplus	1,922,574	839,064	622,7[illegible]2	563,9[illegible]2	397,752
Total Liabilities	$5 3[illegible]6 236	$5 13[illegible] 74[illegible]	$4 8[illegible]1 815	$4 524 2[illegible]7	$4 459 526
Net Working Capital	$ 550 706	$ 2[illegible]8 6[illegible]6	$ 56 898	$ 172 835	$ 1[illegible]5 108
Current Ratio	2 94	[illegible]41	1 14	1 42	1 54
Tangible Net Worth	$2 572 574	$2 389 064	$2 172 712	$2 113 002	$1 397 752
Net Sales	$2 400 885	$1 354 239	$ 917 021	$ 830 000	$ 994 127
Net Profits	82 127	145 [illegible]	187 152[illegible]	59 7[illegible]	165 25[illegible]
Dividends	68 822	38 500	29 250	None	None

downward trend of the business over the five year period. Sales fell off from year to year and for year B amounted to only $830 000, 34 5 per cent of the sales handled in year E. As a result of the decreased sales and heavy annual interest payments on the timber purchase serial notes, losses were assumed in each of the four years from D to A. These losses and the annual payments of $250 000 on the timber purchase notes brought about a shrinkage in the current assets, so that the net working capital in year C was only $56 898 compared to $550 706 in year E. This was an impossible situation

In year B every possible item of expense was cut to the bone. Even

then a loss of $59,710 was sustained. A piece of property and a sawmill not in use were sold for cash. These funds brought about a much-needed but only moderate increase in net working capital from $56,898 to $170,835. Matters looked pretty hopeless. The value of the fixed assets, consisting of real estate, timberlands, plant, and equipment, was 80 per cent in excess of the tangible net worth, and the net working capital was only 8.5 per cent as large as the aggregate of the three issues of funded liabilities.

As a result of the substantial losses, the corporation had become a steady borrower at its bank. In year B the bank debt had been reduced from $100,000 to $50,000. The concern was unable to liquidate this loan as agreed, and Mr. Raymond, vice-president of the bank who had handled the loan, urged that steps be taken to obtain an easement of the conditions of payment in the timber purchase contract as the only possible means of improving the situation. Negotiations along these lines were commenced, but were not concluded until June, year A, when a new timber contract was arranged. Under this new contract the $550,000 of 7 per cent cumulative preferred stock held by the timber vendors was returned for cancellation. That amount was added to the unpaid balance due under a new contract, and the entire liability for the timber purchase, now amounting to $2,139,609, was made payable at the rate of $3.50 per thousand feet of timber cut. Simultaneously the interest was reduced from 7 to 3 per cent per annum.

General conditions in the lumber business during year A were unfavorable, and a substantial loss of $165,250 resulted, almost three times as large as the net loss assumed in the preceding year. The volume of sales was still too small to carry the overhead and the revamped fixed charges. In October, year A, the bank made a formal demand for payment of its loans, still amounting to $50,000. The president of the corporation pleaded for additional time, claiming that to repay the loan would necessitate closing down the plant and liquidating the inventory under pressure, probably to the ruination of the business. Under such a situation it would be impossible to pay the interest on the outstanding $195,000 first mortgage bonds and $419,700 notes secured by the railroad and rolling stock, both of which would then fall due in accordance with the acceleration clauses in the indentures covering these mortgages. After further consideration, an extension of ninety days was granted.

In February, following the end of year A, evidence was produced showing the holders of the timber purchase contract that the terms were

still too onerous for the corporation to meet If the corporation were held to the contract, the only result would be bankruptcy It was suggested that the deal be canceled, that the holders of the timber purchase serial notes take back the timberlands, and that the Box Lumber Company, Inc., enter into a timber-cutting contract, which would be less burdensome This was finally agreed The bank was now advised that the revision of the timber contract was assured

On the strength of these actual and prospective improvements, the corporation now made application for a loan of $125,000 on its plain note, of which $75,000 would be used for seasonal operations and $50,000 to renew the existing loan The vice-president of the bank proceeded to analyze the figures for year A more carefully and requested information about a number of the items on the balance sheet He received the following explanations

COMMENTS ON STATEMENT OF DECEMBER 31, YEAR A

Notes Receivable		$ 12,007
These were current items, mostly trade acceptances, given for box shook and lumber The makers were responsible concerns and the paper could be valued at face		
Accounts Receivable		74,629
All doubtful items had been deducted		
Investments		37,935
Stocks in two selling organizations which were owned by mills in Northern California The real value was nominal		
Sundry Accounts Receivable		85,554
Stumpage advance	$15,000	
Due for equipment sold	10,190	
Slow and doubtful accounts	60,364	
The last item includes about $50,000 due from one lumber dealer who found himself in difficulties in Year B At least fifty per cent recovery was expected The other accounts included in the total were the accumulation of the past few years and of doubtful value		
Accounts Payable		48,896
These items arose from current operations and were being settled in thirty to ninety days A shortage of cash had made it impossible to take advantage of discounts.		
Taxes		90,700
Arrears which had accumulated in the past three years on real estate and personal property Recent state enactments permitted these arrears to be paid in ten annual instalments, provided current taxes were being paid		

Other Liabilities	117,869
Of this sum $90,000 represented notes payable given for timber and logs and $27,869 trade acceptances for logs.	
First Mortgage Bonds	195,000
Secured by a first mortgage on the plant and equipment.	
Mortgage Notes on Railroad	419,700
Part of these notes were held by the construction company which put through the railroad, part by the corporation which had supplied the rolling stock, and part by concerns that wanted to be sure that they would get certain freight business.	
Timber Purchase Serial Notes	$2,139,609
This contract was in process of cancellation as already explained, which would remove the liability as well as the interest on the obligation.	

After four very unprofitable years the concern now found itself in an extremely weak current position, but with business showing some improvement. Sales in year A were roughly 20 per cent above year B, and present indications were that both prices and demand were on the upgrade. Building was increasing noticeably on the Pacific Coast.

Under improved conditions it would probably take two years to put the business back on a profitable basis and considerably more time to show any real improvement in the net working capital. Furthermore, as sales increased, the difficulty of financing the business would be greater. If the outstanding $50,000 loan was not to be renewed, there was only one way to collect in the near future. As the enterprise had no other source of bank credit available, operations would need to be shut down completely, and the assets liquidated for whatever price they would bring.

The banker had made a careful study of this involved situation. The management was conscientious and sincere. Their troubles had been brought on by ambition which had led to overexpansion. That situation was now largely corrected, but the financial condition of the business was extremely weak.

Summary

History: This business had been incorporated in 1919 and had operated successfully up to about five years ago.

Method of operation: The concern operated a sawmill. box factory, planing mill, dry kilns, and a lumber yard. It also had extensive holdings of timberland which were being paid for from one year to another.

Bank and trade information There had been no unfavorable experiences up to five years ago Since then bank loans had been steady, and trade payments had been made irregularly

Financial Information At the time of the request for credit based on the balance sheet for year A, the net working capital had shown a marked decline However, the new arrangements for canceling the burdensome timber purchase contract agreement made a substantial change in the prospects for the concern

Conclusion The banker decided to grant the application for additional credit but only if adequate security were provided This would mean the establishment of a field warehouse at the plant through the agency of one of the local warehouse companies Loans would be made at the rate of $10 per thousand feet of lumber, which would have to run at least 35 per cent number two shop or better, warehouse receipts to be given as security Releases would be granted on payment only, at the same rate of $10 per thousand feet of lumber

Questions for Study

1 In view of the record of the corporation, do you believe the bank was justified in granting the credit? Why?

2 Would you criticize the dividend policy?

3 Are there any ratios in the comparative balance sheets that you consider poor?

4 What particular hazards might confront this industry?

5 Is there any other way in which the loaning officer might have safeguarded his bank when he agreed to extend the credit on a secured basis?

6 Could the field warehouse be operated by the lumber company? Explain fully

Loan to a Department Store

The Stator Department Store, Inc , was incorporated in 1900 under the laws of the State of Idaho with a paid in capital of $220,000 Until about four years ago the earning record had been excellent The board of directors, however, had followed the policy of distributing a high percentage of the annual net income as dividends In year C, following an operating loss, the payment of dividends was discontinued, and after almost as large a loss in year B, a change was made in the active manage-

ment. In year B, a readjustment in the capital structure was made, the par value of the stock being reduced from $100 to $50 and the difference of $2,935,850 added to the surplus account to prevent a deficit.

For several years up to and including year A, the credit requirements of the business had been obtained partly from two depositories in central reserve cities and partly in the commercial paper market. During year A, the commercial paper broker handling the account indicated that, in view of the heavy losses for the two preceding years, he did not feel he would be able to resell the notes. In this situation the president of the corporation turned to a local depository bank to arrange for an additional line of credit.

The bank was well acquainted with the business as an important local enterprise and also through the purchase of its notes in the open market. As a consequence, when the request for a line of credit was received, its credit file was practically up to date. Trade information compiled by Dun & Bradstreet, Inc., at periodic intervals had disclosed the fact that invoices had been discounted or paid promptly for many years. A desirable account with balances averaging around $50,000 had been maintained for several years, so a request was made for an unsecured line of that bank's legal limit, which was $250,000.

The vice-president of the bank had received financial statements from the commercial paper broker over the years, but on the request for the unsecured line of credit, he asked for complete audit reports covering the last four fiscal periods. On receipt of these reports, the preceding condensed comparative balance sheets (Figure 157) were posted for the years D to A, inclusive, on the bank's statement blank.

The banker then proceeded to study these figures. Operations had resulted in substantial losses in years C and B and a moderate loss of $5,179 in year A. In fact, operations for year A indicated a noticeable trend for the better. In spite of the losses of these three years, the financial statement as of December 31, year A, showed a healthy relationship between current assets and current liabilities. The current assets were $3,930,457, and the current liabilities only $747,950.

Like many department stores, this corporation was handling a large charge account business. The accounts receivable had decreased from $1,665,076 to $902,275 between years D and A, but at the same time instalment contracts receivable had increased from $85,296 to $193,978. Both items were of considerable importance on December 31, year A. The auditors reported the following schedule of accounts receivable and stated that all bad and doubtful accounts had been charged off.

Age of Accounts Receivable

	Per Cent
Under 60 days	75 5
60 to 90 days	12 5
Over 90 days	12 0
	100 0

This aging showed a fairly satisfactory condition Accounts sixty days or less old are generally considered in date for a department store The

Figure 157 Comparative Balance Sheets for Stator Department Store Inc (*for years ended December 31, 19—*)

ASSETS	(D) 4 Years Ago	(C) 3 Years Ago	(B) 2 Years Ago	(A) 1 Year Ago
Cash	$ 608 290	$ 333 617	$ 247 682	$ 278 161
Accounts Receivable	1 665 076	1 297 580	1 030 361	902 275
Instalment Contracts Receivable	85 296	135 450	170 347	193 978
Merchandise	2 641 497	2 331 890	1 932 772	2 556 043
Current Assets	$5 000 159	$4 098 537	$3 381 162	$3 930 457
Land	548 669	558 417	398 876	398 876
Buildings	1 259 593	1 281 743	1 186 322	1 147 626
Furniture and Fixtures	176 160	191 873	212 589	229 568
Machinery and Autos	96 597	88 548	72 033	74 412
Real Estate Not Used in Business	57 799	48 452	278 086	279 456
Notes and Accounts Not Current	133 618	92 273	109 624	4 961
Stocks in Other Corporations	113 274	103 274	115 441	134 696
Other Assets	88 427	104 999	347 312	81 863
Deferred Charges	35 508	43 325	48 403	40 283
Total Assets	$7 509 804	$6 611 441	$6 149 848	$6 322 198
LIABILITIES				
Notes Payable	$ 601 966	$ 207 500	$ 304 200	$ 376 000
Accounts Payable	264 128	290 115	248 436	350 721
Accruals	32 971	28 541	17 785	21 229
Current Liabilities	$ 899 065	$ 526 156	$ 570 421	$ 747 950
Common Stock	5 871 700	5 871 700	2 935 850	2 935 850
Surplus	739 039	213 585	2 643 577	2 638 398
Total Liabilities	$7 509 804	$6 611 441	$6 149 848	$6 322 198
Net Working Capital	$4 101 094	$3 572 381	$2 810 741	$3 182 507
Current Ratio	5 56	7 79	5 93	5 26
Tangible Net Worth	$6 610 739	$6 085 285	$5 579 427	$5 574 248
Net Sales	$6 703 660	$5 550 358	$4 467 479	$4 816 732
Net Profits	136 360	525 454L	505 858L	5 179L
Dividends	176 151	None	None	None

proportion of receivables more than sixty days old—12 5 per cent from sixty to ninety days and 12 per cent over ninety days—was about normal Even though all bad and doubtful accounts had been charged off, undoubtedly there were some losses in this last group A further examination of the audit showed that loans amounting to $62 000 due from officers and employees had been included in the current receivables

The instalment sales had developed largely in recent years, and a very small proportion represented accounts on which no payments had been made for sixty days.

The inventory was valued at cost, which was below market. It had fluctuated considerably over the four-year period and at the end of year A amounted to $2,556,043. When compared with the net sales of $4,816,732 for year A, the inventory was certainly heavy. Whereas the typical midwestern department store had an inventory that was only one quarter or one third as large as the annual net sales, here the inventory was more than 50 per cent of the net sales. This low turnover undoubtedly was one of the fundamental reasons for the operating losses.

The liabilities, however, were moderate. Fixed assets were free from mortgage debt and valued at cost, less depreciation to date, at rates used for Federal income tax purposes. The assessed value was within 80 per cent of the carrying value. Adequate insurance was carried on merchandise and fixed assets.

As soon as the request for the line of credit was made, inquiries were mailed to the two out-of-town depositories. The replies indicated that each bank was granting an unsecured line of $500,000 and borrowings were customarily liquidated each year. Half of each line was in current use. Relations had been most satisfactory over the years.

Department store sales were on the increase in the territory that this store served, and the outlook for the immediate future was brightening.

Summary

History: The concern had had a long and successful earning record except for the last three years.

Method of operation: The business was carried on as a typical retail department store, such as one finds in any city of one hundred thousand or over. A substantial charge account business and growing instalment sales were being handled.

Bank and trade information: All reports were favorable.

Financial information: The current condition was satisfactory and the net working capital more than adequate for the line of credit requested. There was no funded debt.

Conclusion: The unsecured line of credit for $250,000 was granted. It is interesting to note that in the first six months of the current year (following the close of year A), the bank debt was paid off and a net profit of $130,000 earned. Sales were considerably ahead of the volume

for the first six months of year A At the same time the inventory was reduced to $1,960 000 Apparently the new management realized its problems and had made headway in solving them

Questions for Study

1 Would you include receivables from officers and employees in the current assets?

2 Work out at least four ratios for each of the four years, and comment on the trends indicated

3 How large a line of unsecured credit would you grant to this concern? Give reasons for your answer

4 What do you think are the principal problems which confront the management of a department store and about which the banker should be informed?

5 If the capital stock in this corporation were held by the members of one family, would you as a banker require guarantees by the principal owners on any loans made to the concern? Why?

Workout of a Wholesale Grocery Company Loan

J D Gray Wholesale Grocery Co, Inc had its inception on the Pacific Coast in 1890 Control had remained continuously in the hands of the same family In its early years the business enjoyed a rapid growth, but about seventeen years ago, when the tangible net worth had increased to $1,750 000, operations reached a point of stagnation with the result that for the ensuing ten years dividends in excess of earnings resulted in a gradual reduction in tangible net worth to $1,470 000

Banking relations ever since the organization of the enterprise had been maintained with one institution, where unsecured loans for as much as $600,000 had been made during widely separated years for seasonal needs About six years ago, year F, after the company had been out of the bank's debt for two years, it made a request for unsecured credit which might run to $500 000 In view of the nature of the relationship, which had not involved borrowing for two years, the bankers had not carefully followed the current trend of the business Based on an analysis of the December 31, year G, balance sheet, the attractive balances, the favorable reputation of the management, and the pleasant relations over many years, the credit was made available, but with the understanding that a definite open com

mitment would be decided only after receipt and analysis of the figures covering operations for the full year F.

The December 31, year F, figures were received early the following February. A digest of the figures for both years G and F was then made on the bank's comparative statement form (see Figure 158).

Figure 158 Comparative Balance Sheets for J. D. Gray Wholesale Grocery Co., Inc.

	(G) Seven Years Ago Dec. 31	(F) Six Years Ago Dec. 31	(E) Five Years Ago Sept. 30
ASSETS			
Cash	$ 160,584	$ 103,152	$ 40,050
Accounts Receivable	493,438	538,526	296,742
Inventory	1,015,970	1,116,470	1,160,076
Current Assets	$1,669,992	$1,758,148	$1,496,868
Fixed Assets	140,600	146,882	313,552
Slow Receivables	197,106	233,382	289,098
Other Assets	-	-	70,354
Total Assets	$2,007,698	$2,138,412	$2,169,872
LIABILITIES			
Notes Payable	$ 290,000	$ 490,000	$ 440,000
Accounts Payable	119,500	129,760	308,218
Current Liabilities	$ 409,500	$ 619,760	$ 748,218
Common Stock	1,000,000	1,000,000	1,000,000
Surplus	598,198	518,652	421,654
Total Liabilities	$2,007,698	$2,138,412	$2,169,872
Net Working Capital	$1,260,492	$1,138,388	$ 748,650
Current Ratio	4.07	2.83	2.00
Tangible Net Worth	$1,598,198	$1,518,652	$1,421,654
Net Sales	$3,388,000	$3,604,000	$2,804,000
Net Profits	21,654	19,546L	51,998L
Dividends	60,000	60,000	45,000

On the basis of the net sales of $3,604,000 for year F, the accounts receivable showed an average collection period of fifty-three days compared with net selling terms of 2 per cent discount in ten days, net thirty days. The receivables apparently were somewhat out of line. The inventory was turning over at the rate of about three times per year, as compared with an average of approximately six times for other important grocery wholesalers in the same part of the country. The president ascribed this situation to intense competition from chain stores, which was said to be forcing wholesalers to be more lenient in their collection

policies so that independent retail grocers could compete and carry larger stocks for their retail customers

To counteract this movement, the management had begun to invest in its own retail outlets It became apparent in the latter half of year E that somewhat over $150,000 of the $500,000 loan the bank had extended was being used for this purpose When the vice president of the bank who was handling the loan learned of this situation, he immediately raised the question of whether the management was qualified to operate successfully in this new field

Between years G and F a moderate reduction had taken place in both the net working capital and the tangible net worth The shrinkage in these items was occasioned by the net operating loss of $19,546 during year F and the payment of dividends of $60,000 out of surplus The unsatisfactory trend was so apparent that reports of credit agencies issued in year E criticized the concern for its low inventory turnover and its inability to show progress Although liabilities were moderate and the bank had adequate protection for its loan, the banker was not satisfied with the situation He requested that a complete independent audit be prepared as of September 30, year E, so that he would know the exact financial condition This audit revealed unimpressive figures, which are posted in the third column in Figure 158

These figures revealed a net loss of $51,998 for the first nine months of the year compared with a loss of $19,546 for the full previous year, a further increase in the inventory, continued dividend disbursements out of surplus, and an expansion in fixed assets from $146,882 to $313,552 An aging of the receivables showed substantially more slow accounts than seemed to be the case by determining the average collection period

These generally unsatisfactory trends led the banker to decide to place the loan on a liquidating basis In January, year D, he requested that no further dividends be paid and that monthly financial statements be submitted to him so that he could follow the condition of the business more closely The management understood the criticism and the banker's point of view, but at the same time the president expressed the hope that it might be possible to improve the condition of the business by moving more actively into the chain store field

Borrowings had been steady throughout year E and at the opening of year D amounted to $490,000 During the first half of year E the banker had held several discussions with the management for the purpose of obtaining full information regarding the financial condition of the corpo-

ration in order to determine what steps should be taken to liquidate the note. When the December 31, year E, balance sheet was issued, it showed some improvement over the figures that had been issued three months previously. The cash position was nominal, but the inventory had been reduced and accounts payable paid down substantially. The profit during the last three months of the year had almost wiped out the loss of the first nine months.

Figure 159 Comparative Balance Sheets for J. D. Gray Wholesale Grocery Co., Inc. (*years ended December 31, 19–*)

	(E) Five Years Ago	(D) Four Years Ago	(C) Three Years Ago
ASSETS			
Cash	$ 2,062	$ 22,868	$ 61,462
Accounts Receivable	443,182	331,572	173,872
Inventory	872,866	517,498	481,412
Current Assets	$1,318,110	$ 871,938	$ 716,746
Fixed Assets	493,468	597,942	283,992
Slow Receivables	178,480	134,790	129,484
Other Assets	-	-	13,514
Total Assets	$1,990,058	$1,604,670	$1,143,736
LIABILITIES			
Notes Payable	$ 440,000	$ 150,000	$ -
Accounts Payable	79,050	70,784	57,408
Current Liabilities	$ 519,050	$ 220,784	$ 57,408
Common Stock	1,000,000	1,000,000	1,000,000
Surplus	471,008	383,886	86,328
Total Liabilities	$1,990,058	$1,604,670	$1,143,736
Net Working Capital	$ 799,060	$ 651,154	$ 659,338
Current Ratio	2.53	3.94	12.48
Tangible Net Worth	$1,471,008	$1,383,886	$1,086,328
Net Sales	$3,158,000	$2,056,000	-
Net Profits	2,644L	72,122L	-
Dividends	45,000	15,000	-

Despite this improvement during the last three months of the year, the vice-president of the bank was desirous of retiring the credit and insisted that dividends be discontinued as of July 1, year D. With the management he worked out a program of gradual liquidation, deciding to require a minimum monthly payment of $20,000. It was obvious that before long this schedule would force the concern to liquidate either the wholesale or the retail division of the business. By the middle of year D the concern owned fifty-six retail store units, which had brought about an increase in

fixed assets of $451,060 within a two year period and a consequent steady and noticeable reduction in the net working capital

Shortly after being advised of the bank's decision the management determined to reduce the wholesale end of the business and to liquidate its stores in the retail field

Between the early part of year D and October, year C, a period of about twenty months, the complete liquidation of the indebtedness to the bank was accomplished by regular monthly payments This program was accomplished, first, through the reduction of the excessive inventory and extended receivables, and, later, through the gradual liquidation of the retail stores This process eventually freed an investment of about $600,000 to apply on the liabilities Only the specialty foods business was continued in the wholesale field

In the three years following the successful workout of the bank's loan, the management continued the process of gradual liquidation The retail units continued to be sold one or two at a time at less than carrying values, until they were completely eliminated This process of course, caused a steady reduction in the net worth of the organization and meant unprofitable operations

At present the business is confined to the wholesaling of specialty food items, a field in which operations have been moderately expanded On a much reduced scale the financial condition of the corporation is again strong, and the original owners continue to operate in a field that was originally a side line The advances by the bank to the concern are now confined to relatively small unsecured amounts for short periods, all of which have been handled satisfactorily

Summary

History The business had a long record of growth, but about seventeen years ago it seemed to reach a point of stagnation

Method of operation It operated as a service wholesale grocery When competition arose from chain stores, the management established an increasing number of its own retail outlets without realizing its own inexperience in this field

Bank and trade information Bank and trade relations were favorable up to the time the concern went into retail operations Then borrowings became somewhat steady

Financial information Dividends were continued in spite of unprofitable operations The balance sheet on which credit was extended reflected

only a fairly satisfactory condition. The slow turnover of inventory, extended receivables, and additional investment in retail outlets made it somewhat difficult to liquidate the loan.

Conclusion: The banker granted the request for credit, a large portion of which later went into new retail outlets. The loan was repaid only by working out a program with the management calling for monthly payments.

Questions for Study

1. Did the banker make the proper study of this request for credit before it was granted? Why?
2. Was the amount of credit requested excessive?
3. What dangers confronted the business in its expansion program?
4. Assume you were the active manager of this corporation. What policies would you have established regarding the payment of dividends?

Loan Based upon Interim Statements

Often small companies do not furnish financial statements prepared by outside accountants; their figures are usually prepared by their own bookkeeper. The case of the Ace Baking Company illustrates the fallacy of granting credit based upon such interim statements without thoroughly analyzing the various accounts and taking into consideration adjustments made by auditors in preparing fiscal statements.

The stock of this company is jointly owned by Messrs. Green and Brown, who have applied to the bank for a loan of $20,000 for ninety days to retire notes payable to the local bank and to the trade and to increase cash balances. They list as their personal assets their interests in the business, their equity in their homes, and rather nominal personal bank accounts. The men are forty and forty-six years of age, respectively, and well experienced in their field of manufacturing and distributing food products, consisting primarily of wrapped bread under their own labels.

Summary

History: The company was incorporated nine years ago and has operated at a profit each year. Most of the profits are drawn out in salaries, and no dividends have ever been paid.

Method of operation: Sales and purchases are spread evenly throughout

the year, and both terms are on a 2 per cent in ten days, net thirty days basis

Bank information Bank balances have been nominal with no overdrafts Loans have been in a reasonable amount, with no clean-up established in the past three years

Trade information Most creditors report slowness in the trade, some shipments on a C O D basis

Financial information Statements offered present favorable ratios, usually used in determining the goodness of the credit Current assets are twice the amount of current liabilities Cash and receivables, as reported, exceed current debt Net worth is approximately equal to total debt

Conclusion The application for credit was refused after thoroughly analyzing the statements (see Figures 160 and 161) and arriving at the following conclusions

Figure 160 Balance Sheet for Ace Baking Company *(October 31, 19–)*

ASSETS			
Cash Second National Bank		$ 3 915	
Accounts Receivable		91,755	
Inventory			
Raw Material	$18 094		
In Process	7 763		
Finished Goods	24 343	50,200	
Due from Employees		3 392	
Investments		3 000	
Current Assets			$152 262
Fixed Assets			
Machinery and Equipment		$24 093	
Less Reserve for Depreciation		21 362	2 731
Deferred Expense			938
Total Assets			$155 931
LIABILITIES			
Notes Payable Second National Bank		$ 6,000	
Notes Payable Trade		9 180	
Accounts Payable Trade		57 242	
Reserve for FICA and Other Taxes		3 111	
Current Liabilities			$ 75 533
Chattel Mortgage Due After One Year			1,837
Balance of Undrawn Officers Salaries			2 589
Net Worth			
Capital Stock Outstanding		$37 500	
Earned Surplus January 1 19__		14 745	
Net Profit - 10 Months to October 31 19__		23 727	$ 75 972
Total Liabilities and Net Worth			$155 931

Working Capital $76 729

1. Bank credit required: Trade debt exceeds one month's cost of materials sold by $45,000, which would be needed to place the accounts on a thirty-day basis. A clean-up is also required of the bank notes for $6,000 and trade notes for $9,180. In addition, the profit and loss, or operating, statement shows return allowances equal to 10 per cent of sales, which is undoubtedly due to faulty equipment, shown on the balance sheet as having depreciated to $2,731. This can be corrected only by the purchase

Figure 161 Profit and Loss Statement for Ace Baking Company (*10 months ended October 31, 19–*)

Sales		$301,668	
Less: Returns and Allowances		30,177	
Net Sales			$271,491
Cost of Goods Sold			
Inventory January 1, 19__		$ 43,741	
Purchases		178,668	
		$222,409	
Less Inventory October 31, 19__		50,199	
Cost of Material Sold		$172,210	
Direct Labor		24,186	
Manufacturing Expense:			
Indirect Labor	$ 3,618		
Rent	9,189		
Freight	837		
Supplies	657	$ 14,301	
Cost of Goods Sold			$210,697
Gross Profit			$ 60,794
Other Expense			
Office Wages		$ 9,261	
Advertising		1,143	
Commissions		18,174	
Tel. & Tel.		1,740	
Office Supplies		846	
Freight and Postage		956	
Insurance		1,041	
Accounting Service		558	
Auto Expense		936	
Miscellaneous		2,412	$ 37,067
Net Profit			$ 23,727

of additional equipment which, at present prices, would cost approximately $40,000.

Bank balances should be increased by about $5,000 to aggregate one month's operating costs, excluding purchases. Thus, total bank credit required amounts to $90,000, as compared with the $20,000 requested.

2. Adjustments to operating results: As previously mentioned, salaries are withdrawn at the end of each year when profits are determined, but this statement shows no such charges. As a matter of fact, the balance sheet shows a balance of undrawn salaries for the previous year of $2,580.

The earned surplus for the nine years' operations indicates that an average of only \$1,500 is retained in the business each year It is, therefore, reasonable to lower the operating profit by \$14,000 and accrue this as a liability

The balance sheet shows no accrual for commissions, although the operating statement shows this charge averages \$1,800 per month. It is, therefore, reasonable to charge \$3,000 to operations and set up this as accrual liability

These adjustments lower the net profit to \$6,000, of which \$2,000 will have to be set up as an income tax accrual This results in a net profit, after taxes, of about \$4,000 as compared with total credit needs of \$90,000 Inasmuch as this company is not on a seasonal basis, its only means of repayment would be through profits

3 Balance sheet adjustments In addition to the aforementioned adjustments totaling \$19,000, working capital would further be reduced by reclassifying as non-current \$3,392 due from employees and \$3,000 of investments, which are advances to an affiliate, and showing as current liability the balance due on officers' salaries totaling \$2,589

After considering these items, ratios previously mentioned have been considerably reduced beyond what is considered the rule of thumb in analyzing financial statements

Questions for Study

1 Determine the amount of past-due items in accounts receivable, and comment on the company's apparent collection policy

2 Determine the number of months' cost of sales that is represented in inventory, and comment on this turnover in this particular industry

3 In rejecting this application, what advice would you offer in lieu of credit?

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about the authors

HERBERT V PROCHNOW, President of the First National Bank of Chicago, is an accomplished author and speaker, as well as a prominent economist. He is the author of a number of books for public speakers and editor of *The Federal Reserve System* He served as Deputy Under Secretary of State for Economic Affairs during the Eisenhower administration, and has been Alternate Governor for the United States of the International Bank and International Monetary Fund, and a member of the delegation to the Organization for European Economic Cooperation

ROY A FOULKE, until recently a Vice President and member of the Board of Directors of Dun & Bradstreet, Inc., is the author of *Behind the Scenes of Business*, *The Sinews of American Commerce*, and *Practical Financial Statement Analysis* He retired in 1961 after an active career that included affiliation with the Liberty National Bank, New York City, the National Credit Office Inc New York City, and Payne, Webber & Company